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No. 83

In the Supreme Court of the United States

OCTOBER TERM, 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MARGARET R. PHIPPS

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Specification of error to be urged	5
Summary of argument	5
Argument: The deficits of the four liquidated subsidiaries did not extinguish the accumulated earnings or profits of the parent corporation	10
Introduction	10
A. Application of the *Sansome* rule to permit a parent corporation to inherit the deficits of its subsidiaries runs counter to the purpose of that rule to prevent tax avoidance	15
B. The legislative and administrative confirmation of the principle announced in the *Sansome* case did not extend that principle to embrace the inheritance of deficits which, as a practical matter, are not transferred in the course of a reorganization or liquidation	22
C. Application of the *Sansome* rule to permit the inheritance of a deficit would frustrate the explicit Congressional direction that unrecognized losses not reduce earnings	29
D. The reading put upon the *Sansome* rule by the court below finds no support in prior decisions	40
E. The decision of the court below is squarely in conflict with the Congressional assumption as to the scope of the *Sansome* rule as evidenced in the statutory provisions dealing with the computation of equity invested capital for excess profits tax purposes	49
Conclusion	67
Appendix	68

CITATIONS

Cases:	
Baker v. *Commissioner*, 80 F. 2d 813	13
Barnes v. *United States*, 22 F. Supp. 282	13
Bazley v. *Commissioner*, 331 U. S. 737	18
Beretta v. *Commissioner*, 141 F. 2d 452, certiorari denied, 323 U. S. 720	11

Cases—Continued

	Page
Blair v. *United States*, 63 C. Cls. 193, certiorari denied, 275 U. S. 546	46
Brooklyn National Corp. v. *Commissioner*, 157 F. 2d 450, certiorari denied, 329 U. S. 733	46
Campbell v. *United States*, 144 F. 2d 177	14, 17, 21
Commissioner v. *Estate of Bedford*, 325 U. S. 283	13
Commissioner v. *W. S. Farish & Co.*, 104 F. 2d 833	46
Commissioner v. *Fisher*, 327 U. S. 512	30
Commissioner v. *Munter*, 331 U. S. 210	6, 13, 14, 15, 17, 21, 25, 27, 36
Commissioner v. *National Carbide Corp.*, 167 F. 2d 304, pending on certiorari Nos. 151–153, this Term	32
Commissioner v. *Sansome*, 60 F. 2d 931, certiorari denied, 287 U. S. 667	13, 19, 20, 21, 40
Commissioner v. *South Texas Co.*, 333 U. S. 496	50
Commissioner v. *Wheeler*, 324 U. S. 542, rehearing denied, 325 U. S. 892	28, 30, 31, 36, 39
Cranson v. *United States*, decided November 12, 1943, affirmed, 451 F. 2d 1021	43
Cranson v. *United States*, 146 F. 2d 871, certiorari denied, 326 U. S. 717	25, 26, 40, 41, 42, 43, 44
Crocker v. *Commissioner*, 29 B. T. A. 773	13, 22, 48
Crossett Western Co. v. *Commissioner*, 155 F. 2d 433, certiorari denied, 329 U. S. 729	13, 54
Deputy v. *du Pont*, 308 U. S. 488	38
Foley Securities Corp. v. *Commissioner*, 106 F. 2d 731	46
Geerday Enterprises v. *Commissioner*, 126 F. 2d 384	13
Gregory v. *Helvering*, 293 U. S. 465	18
Harter v. *Helvering*, 79 F. 2d 12	44, 45, 47
Helvering v. *Credit Alliance Corp.*, 122 F. 2d 361, affirmed, 316 U. S. 107	14
Interstate Transit Lines v. *Commissioner*, 319 U. S. 590	32, 38
Mandel v. *Commissioner*, 5 T. C. 684	13, 48
McClintic, Estate of v. *Commissioner*, 47 B. T. A. 188	13
Moline Properties v. *Commissioner*, 319 U. S. 436	32
Murchison's Estate v. *Commissioner*, 76 F. 2d 671	13, 17
New Colonial Co. v. *Helvering*, 292 U. S. 435	22, 32, 39
New Colonial Ice Co. v. *Commissioner*, 66 F. 2d 480	22
Pembroke Realty & S. Corp. v. *Commissioner*, 122 F. 2d 252	46
Putnam v. *United States*, 149 F. 2d 721	13, 17, 22, 37
Reed Drug Co. v. *Commissioner*, 130 F. 2d 288	13, 22
Riverside Cement Co. v. *Rogan*, 59 F. Supp. 401	13
Robinette v. *Commissioner*, 148 F. 2d 513	14
Sale v. *Commissioner*, 35 B. T. A. 938	46
Senior Investment Corp. v. *Commissioner*, 2 T. C. 124, petition for review dismissed February 5, 1947	47
Slover v. *Commissioner*, 6 T. C. 884	14, 17

Cases—Continued Page

Taylor-Wharton Iron & Steel Co. v. *Commissioner*, 5 T. C. 768 ..... 33, 59

United States v. *Kauffman*, 62 F. 2d 1045 13

United States v. *Ogilvie Hardware Co.*, 330 U. S. 709 27

Van Norman Co. v. *Welch*, 141 F. 2d 99 46

White v. *United States*, 305 U. S. 281 39

Willcuts v. *Milton Dairy Co.*, 275 U. S. 215 ..... 26, 27, 46

Statutes:

Internal Revenue Code:

Sec. 113 (26 U. S. C. 1946 ed., Sec. 113) 57

Sec. 115 (26 U. S. C. 1946 ed., Sec. 115) 7, 24, 30, 34, 37, 72

Sec. 129 (26 U. S. C. 1946 ed., Sec. 129) 18, 32

Sec. 710 (26 U. S. C. 1946 ed., Sec. 710) 49

Sec. 711 (26 U. S. C. 1946 ed., Sec. 711) 49

Sec. 712 (26 U. S. C. 1946 ed., Sec. 712) 49

Sec. 714 (26 U. S. C. 1946 ed., Sec. 714) 50

Sec. 717 (26 U. S. C. 1946 ed., Sec. 717) 50

Sec. 718 (26 U. S. C. 1946 ed., Sec. 718) 9, 10, 50, 51, 52, 53, 54, 55, 56, 57, 58, 60, 61, 62, 63, 65, 66, 74

Sec. 761 (26 U. S. C. 1946 ed., Sec. 761) 61, 62, 79

Revenue Act of 1934, c. 277, 48 Stat. 680, Sec. 115 11

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Sec. 14 11

Sec. 22 ..... 10, 68

Sec. 26 48

Sec. 111 ..... 29, 68

Sec. 112 ..... 15, 30, 34, 57, 58, 69

Sec. 113 ..... 36, 37, 69

Sec. 115 ..... 5, 7, 10, 11, 12, 13, 18, 22, 36, 42, 44, 46, 59, 69

Revenue Act of 1938, c. 289, 52 Stat. 447, Sec. 115 ..... 7, 24, 71

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

Sec. 201 49

Sec. 501 ..... 30, 72

Revenue Act of 1942, c. 619, 56 Stat. 798:

Sec. 219 62

Sec. 230 61

Sec. 501 48

Revenue Act of 1943, c. 63, 58 Stat. 21, Sec. 128 ..... 18-49, 32

Revenue Act of 1945, c. 453, 59 Stat. 556, Sec. 122 49

Miscellaneous:

H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940-2 Cum. Bull. 548) 52, 58

H. Rep. No. 2894, 76th Cong., 3d Sess. (1940-2 Cum. Bull. 496):

P. 25 ..... 52, 53, 56, 57

P. 41 34

Miscellaneous—Continued

	Page
1 Mertens, *Law of Federal Income Taxation*:	
Sec. 5.06	40
Sec. 9.29	40
Sec. 9.30	46
Paul, *Selected Studies in Federal Taxation* (Second Series), pp. 151–152, 166	40
S. Rep. No. 275, 67th Cong., 1st Sess., p. 10 (1939–1 Cum. Bull. (Part 2) 181)	12
S. Rep. No. 2156, 74th Cong., 2d Sess. (1939–1 Cum. Bull. (Part 2) 678):	
P. 18	11, 24
P. 19	23, 24
S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779)	24
S. Rep. No. 1631, 77th Cong., 2d Sess. (1942–2 Cum. Bull. 504):	
Pp. 193–194	53, 63, 64, 66
Pp. 222–228	62
S. Rep. No. 2114, 76th Cong., 3d Sess., (1940–2 Cum. Bull. 528):	
Pp. 6, 14	52
P. 25	35
S. Rep. No. 627, 78th Cong., 1st Sess., pp. 58–61 (1944 Cum. Bull. 973)	33
Treasury Regulations 94:	
Art. 113 (b)–1	33, 87
Art. 115–3	30, 34, 87
Art. 115–11	24, 26, 88
Treasury Regulations 101, Art. 115–11	14, 24, 89
Treasury Regulations 103, Sec. 19.115–11	25
Treasury Regulations 109, Sec. 30.718–2	56
Treasury Regulations 111, Sec. 29.115–11	25

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OPINIONS BELOW.

The opinion of the Tax Court (R. 13–23) is reported at 8 T. C. 190, and the opinions in the Court of Appeals (R. 30–37) are reported at 167 F. 2d 117.

JURISDICTION

The judgment of the Court of Appeals was entered on March 10, 1948 (R. 38). The petition for a writ of certiorari was filed on June 8, 1948, and was granted on October 11, 1948 (R. 40). The jurisdiction of this Court rests on 28 U. S. C. 1254.

QUESTION PRESENTED

The question is whether a cash distribution by a corporation during 1937 to its preferred stockholders, of which the taxpayer received a *pro rata* share, was made from the corporation's accumulated earnings or profits (to the extent that the distribution was in excess of the current earnings for the year 1937) and was consequently taxable in its entirety to the stockholders as a dividend under Sections 22 (a) and 115 (a) of the Revenue Act of 1936. The answer to this question turns on whether or not the corporation's own accumulated earnings or profits as of December 31, 1936, were eliminated by the operating deficits of its wholly owned subsidiaries, the assets of which were acquired in 1936 by the corporation pursuant to complete liquidations which were tax-free under Section 112 (b) (6) of the Revenue Act of 1936.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and Regulations are printed in the Appendix, *infra*, pp. 68–91.

STATEMENT

All the facts were stipulated (R. 10–13) and were found by the Tax Court as stipulated (R. 14). So far as relevant, they are as follows:

During 1937, the taxpayer, the owner of 2,640 shares of preferred stock of Nevada-California Electric Corporation (hereinafter referred to as

"parent corporation"), received a cash distribution on her shares in the amount of $18,480 ($7 per share). Taxpayer's cost basis, for tax purposes, for the preferred stock was in excess of the distribution in 1937. (R. 10.)

The distribution to the taxpayer was a part of a total distribution of $802,284 made *pro rata* by the parent corporation in 1937 to its preferred stockholders. The parent corporation had earnings or profits for the year 1937 of $390,387.02, and 48.6595% of the distribution in 1937 was chargeable to these earnings. (R. 11.)

On December 1, 1936, the parent corporation liquidated five of its wholly owned subsidiaries by distributing to itself all of their assets, subject to liabilities, in complete cancellation and redemption of all of their outstanding stock. No gain or loss was recognized on the liquidations for income tax purposes under Section 112 (b) (6) of the Revenue Act of 1936. (R. 11–12.)

On December 1, 1936, one of the subsidiaries liquidated on that date had earnings or profits accumulated after February 28, 1913, in the amount of $90,362.77. The four other liquidated subsidiaries had deficits in accumulated earnings or profits which aggregated $3,147,803.62. (R. 12.)

On December 31, 1936, the parent corporation had earnings or profits which it had accumulated after February 28, 1913, in the amount of $2,129,957.81. This amount does not include or reflect

either the accumulated earnings of the one subsidiary or the deficits of the four subsidiaries, or the earnings or losses of the subsidiaries. (R. 12–13.)

In her income tax return for 1937, the taxpayer reported the entire amount of $18,480, distributed to her in that year by the parent corporation, as a taxable dividend. Later, however, she filed a claim for refund of $3,882.74 of the tax paid by her for 1937, on the ground that the distribution was not a taxable dividend. (R. 10.) The Commissioner determined that the dividend constituted taxable income in its entirety and so advised the taxpayer in the deficiency letter, which asserted a deficiency in income tax for 1937 resulting from other adjustments which were not challenged by the taxpayer in the petition filed with the Tax Court (R. 6–7, 11; 1–4).

In the Tax Court, the taxpayer conceded that $8,992.28 of the distribution was a taxable dividend since, to that extent (48.6595%), it was paid from current earnings for 1937 (R. 11, 14). The Tax Court held[1] that the balance of the distribution ($9,487.72) was not a taxable dividend paid by the parent corporation out of its earnings or profits accumulated after February 28, 1913, on the theory that all of its accumulated earnings of $2,129,957.81 on December 31, 1936, plus the ac-

[1] Judge Disney's opinion was not reviewed by the whole Tax Court, although the issue involved in the case had not theretofore been squarely decided by the Tax Court.

cumulated earnings of $90,362.77 of the one subsidiary, were erased by the aggregate deficits of $3,147,803.62 of the four subsidiaries (R. 16–23).

The Court of Appeals affirmed this holding, Judge Huxman dissenting (R. 30–37).

SPECIFICATION OF ERROR TO BE URGED

The Court of Appeals erred in holding that the accumulated earnings or profits of the parent corporation at the end of 1936 were extinguished, for taxable dividend purposes, by the deficits of its subsidiaries, the net assets of which the parent acquired during 1936 in tax-free liquidations of the subsidiaries.

SUMMARY OF ARGUMENT

Under Section 115 (a) and (b) of the Revenue Act of 1936, the cash distribution by the parent corporation in 1937 to its stockholders, of which the taxpayer as a stockholder received a *pro rata* share, was a taxable dividend in its entirety. There is no dispute that the distribution was a dividend to the extent of the parent corporation's current earnings for 1937. The remainder of the distribution also represented a taxable dividend because the parent corporation had earnings or profits accumulated after February 28, 1913, greatly in excess of the distribution, to which the distribution is chargeable. We believe that the court below erred in holding that these accumulated earnings had disappeared prior to the distri-

bution by reason of the fact that pursuant to tax-free liquidations in 1936, the parent corporation had acquired the assets of four of its wholly owned subsidiary corporations, which had deficits on their books on the date of their liquidations.

A. The so-called "*Sansome*" rule, applied by this Court in *Commissioner* v. *Munter*, 331 U. S. 210, decrees that where a corporation acquires, pursuant to a tax-free reorganization or liquidation, the assets of another corporation which has accumulated earnings or profits, the earnings of the liquidated corporation remain earnings in the hands of the acquiring corporation and are thereafter available for distribution by it as dividends. In the *Munter* case, this Court explained the *Sansome* rule as necessary to prevent the escape of the predecessor corporation's earnings from taxation as income to the stockholders upon distribution. That reason for applying the rule is absent in the case of a deficit corporation, which has no earnings which will escape tax. Instead, to permit the transfer of a deficit with the consequence that the acquiring corporation's earnings are thereby extinguished or reduced would defeat the legislative purpose, expressed in Section 115 (a) and (b), that corporate earnings are to be taxed as income upon their distribution. The *Sansome* case did not declare, as the lower court thought it did, that the corporation which acquires the assets of another corporation is a mere continuation of that corporation for all tax

purposes; the opinion merely treated the predecessor's earnings or profits as continuing as earnings in the acquiring corporation's hands.

B. Neither Congress, in enacting Section 115 (h) of the Revenue Act of 1936, 1938, and the Internal Revenue Code, nor the Treasury, in promulgating regulations which, like Section 115 (h), incorporate the *Sansome* rule, gave any indication that their references to an inheritance of "earnings and profits" carried with them the thought that deficits of predecessor corporations were also to be carried over. This is not surprising since, as a practical matter and for purposes of corporate accounting, the deficit of the acquired corporation is not, as such, transferred to the acquiring corporation. The existing deficit may cause the acquired assets to be smaller in amount than they would be but for the deficit; but only assets are acquired, deficits are not. In this respect, a situation in which *Sansome* is properly applicable is sharply distinguishable. In such a case, the transferred assets reflect accumulated earnings which do, in fact, pass to the successor corporation.

C. The losing operations of a subsidiary corporation result in a deficit from the standpoint of the subsidiary's accounting, but in a loss to the parent corporation to the extent that the assets received on liquidation by the parent have a value less than its investment in stock of the subsidiary. Under the applicable statute and regu-

lation, the parent corporation's loss, when realized in a liquidation which is tax-free, does not for tax purposes reduce its accumulated earnings or profits. The legislative mandate that a tax-free transaction is to have no effect on earnings or profits would be violated if the earnings were treated as extinguished or reduced by the deficit of the liquidated subsidiary. Moreover, the substitution of the subsidiary's deficit as a deduction from earnings, in place of deduction of the parent's loss which is prohibited by statute, unwarrantedly confuses the two separate corporations and causes the disappearance of the parent's earnings in an amount which is likely not to correspond to the loss which the parent corporation actually sustained.

It was not shown in this case that the parent corporation had a loss on liquidation of the subsidiaries or that its earnings or profits will not in the future, upon disposition of the assets acquired from the subsidiaries, reflect fully the loss on the liquidations, if any. Even if that had been shown, however, it would not warrant reduction of the earnings in 1936 by the deficit, which may be an amount quite different from the loss suffered by the parent. Taxpayer, as a stockholder, will realize any loss actually sustained by her corporation through its effect on the value of her stock, even if the loss on liquidations of the subsidiaries were never to be reflected fully in the

parent corporation's earnings account for tax purposes.

D. In more than sixteen years of litigation involving the *Sansome* rule, no decision, prior to the rulings of the courts below in this case, has extended the *Sansome* principle to treat the deficit of a liquidated corporation as reducing the accumulated earnings of the corporation which acquires its assets, and in the only cases which have directly presented such question, the Court of Appeals for the Ninth Circuit has ruled that the deficit of a liquidated subsidiary corporation is not transferred to the parent corporation which acquired its assets in a non-taxable liquidation.

E. Section 718 of the Internal Revenue Code, which defines "equity invested capital" for excess profits tax purposes, was enacted by Congress on the assumption that the deficit of a corporation which was liquidated or reorganized by another corporation would not be transferred intact to the other corporation in reduction of its accumulated earnings under the *Sansome* doctrine. This is evident from the facts (1) that Congress included no provision increasing invested capital by the amount of the deficit of a reorganized corporation, as it would be expected to have done if the deficit had theretofore reduced accumulated earnings under the *Sansome* rule; (2) that Congress directed an adjustment to invested capital to reflect the loss to a parent corporation upon the tax-free liquidation of a subsidiary corpora-

tion, which adjustment would have been an undesirable duplication, wholly or in part, of the reduction of the parent's accumulated earnings by the subsidiary's deficit if that reduction had previously occurred pursuant to the *Sansome* rule; and (3) that in Section 718 (c) (5) Congress expressly directed that in certain limited circumstances the deficit of a predecessor corporation was to carry over into the earned surplus account of the successor corporation for invested capital purposes, a statutory provision which would have been wholly unnecessary if the *Sansome* rule had operated to transfer deficits. Thus the Congressional understanding of the scope of the *Sansome* rule is at war with that of the court below. Were the decision below to stand, one of the basic factors in the computation of the excess profits tax would be distorted.

ARGUMENT

The Deficits of the Four Liquidated Subsidiaries Did Not Extinguish the Accumulated Earnings or Profits of the Parent Corporation

Introduction.—Section 22 (a) of the Revenue Act of 1936 (Appendix, *infra*, p. 68) includes "dividends" within the definition of gross income. Section 115 (a) of the Act (Appendix, *infra*, pp. 69–70) defines a dividend for purposes of the income tax title as a distribution in money or other property by a corporation to its share-

holders (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings of the taxable year (computed as of the end of the year without diminution for distributions made during the year), without regard to the amount of the earnings or profits (*i. e.*, the accumulated earnings) at the time the distribution was made.[2] Section 115 (b) (Appendix, *infra*, p. 70) provides that, for tax purposes, every distribution is made from earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits, and that only when the earnings or profits accumulated after February 28, 1913, have been distributed will a distribution be deemed to be a return of capital to apply against and reduce the stockholder's adjusted basis for his stock. The presumption as to the source of a distribution established by this Section is a conclusive one for tax purposes (*Beretta* v. *Commissioner*, 141 F. 2d

[2] Prior to Section 115 (a) of the Revenue Act of 1936, a dividend was defined for general income tax purposes as a distribution out of earnings or profits accumulated after February 28, 1913. See, *e. g.*, Section 115 (a), Revenue Act of 1934, c. 277, 48 Stat. 680. The definition of dividend was changed in 1936 to enable all corporations to obtain a dividends-paid credit by distributing the current year's earnings, for purposes of computing the surtax on undistributed profits imposed on corporations by Section 14 of the Revenue Act of 1936, without regard to whether a deficit existed in the earned surplus account at the beginning of the year. S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18 (1939-1 Cum. Bull. (Part 2) 678, 689).

452, 455 (C. C. A. 5th), certiorari denied, 323 U. S. 720; S. Rep. No. 275, 67th Cong., 1st Sess., p. 10 (1939-1 Cum. Bull. (Part 2) 181, 187)), with certain exceptions made in later subsections of Section 115.[3] In accordance with these statutory provisions, the taxpayer properly conceded in the Tax Court (R. 14) that the distribution in cash by the parent corporation to its stockholders in 1937 was a taxable dividend to the extent (48.6595%) that it was covered by the current earnings for 1937.

The only question in this case is whether the $411,896.98 (51.3405%) of the distribution, which was in excess of the current earnings, constituted a taxable dividend. This, in turn, under Section 115 (a) and (b), depends on whether, at the time of the distribution, the parent corporation had earnings or profits accumulated after February 28, 1913, equal to, or in excess of, that amount. At the beginning of the year 1937, the parent corporation had earnings or profits accumulated by it after February 28, 1913, in the amount of $2,129,957.81 (R. 12), which was greatly in excess of the $411,896.98 distributed

[3] Section 115 (c) of the Revenue Act of 1936 provides that distributions in liquidation are to be treated as payments in exchange for the stock and, in the case of a distribution in partial liquidation, the part that is properly chargeable to capital account shall not be considered a distribution of earnings or profits. Section 115 (h) (Appendix, *infra*, pp. 70-71) directs that earnings or profits are not to be considered as distributed by a distribution upon which gain is not recognized by law, or which is a non-taxable stock dividend.

in 1937 which is in dispute here. The conclusion seems therefore to be required, under Section 115 (a) and (b), that the entire distribution is taxable as a dividend to the stockholders of the parent corporation. Cf. *Commissioner* v. *Estate of Bedford*, 325 U. S. 283.

The courts below (R. 30–32; 16–23) held, however, that under the so-called *Sansome* doctrine, the accumulated earnings of the parent corporation were eliminated in their entirety, for dividend purposes, by the deficits, aggregating $3,147,803.62, of four of the five subsidiaries which were liquidated in 1936, and, accordingly, that the 1937 distribution, to the extent of $411,896.98, was from capital.

In *Commissioner* v. *Munter*, 331 U. S. 210, this Court approved and applied the principle, first stated in *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, and since firmly established,[4] that where a cor-

[4] *United States* v. *Kaufmann*, 62 F. 2d 1045 (C. C. A. 9th); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th); *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Geerday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1st); *Crossett Western Co.* v. *Commissioner*, 155 F. 2d 433 (C. C. A. 3d), certiorari denied, 329 U. S. 729; *Barnes* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Riverside Cement Co.* v. *Rogan*, 59 F. Supp. 401 (S. D. Cal.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; *Mandel* v. *Commissioner*, 5 T. C. 684.

poration transfers all or a part of its assets to another corporation in a tax-free reorganization, the accumulated earnings or profits, included in the assets transferred, do not lose their status as earnings or profits in the hands of the acquiring corporation and are available for distribution as dividends by it, despite the fact that for bookkeeping or other purposes the acquired earnings may be treated as capital of the acquiring corporation.[5] The same principle applies to preserve the accumulated earnings or profits of subsidiary corporations as earnings in the hands of the parent corporation which acquires the assets of the subsidiaries in complete liquidations, on which gain or loss is not recognized for tax purposes. *Robinette* v. *Commissioner*, 148 F. 2d 513 (C. C. A. 9th); *Helvering* v. *Credit Alliance Corp.*, 122 F. 2d 361, 364–365 (C. C. A. 4th), affirmed, 316 U. S. 107; Art. 115–11 of Treasury Regulations 101 (Appendix, *infra*, pp. 89–91) which, although promulgated under the Revenue Act of 1938, applies the rule to a distribution of the subsidiary's assets pursuant to a tax-free liquidation made in any year. Under this latter principle, both parties correctly agreed in the Tax

[5] The operation of the *Sansome* rule is restricted to the accumulated earnings which cannot be deemed, for tax purposes, to have been distributed by the corporation, which transferred its assets, to its stockholders in the course of the reorganization. *Commissioner* v. *Munter*, 331 U. S. at 215–216; *Campbell* v. *United States*, 144 F. 2d 177, 181–182 (C. C. A. 3d); *Slover* v. *Commissioner*, 6 T. C. 884.

Court (R. 16) that the accumulated earnings, in the amount of $90,362.77, of the one subsidiary remained earnings in the hands of the parent corporation upon its acquisition of all of the subsidiary's assets in complete liquidation on which gain or loss was not recognized under Section 112 (b) (6) of the Revenue Act of 1936 (Appendix, *infra*, p. 69).

The four other liquidated subsidiaries, however, did not have any earnings or profits to which the *Sansome* rule might apply. Nevertheless, the taxpayer's argument, which both lower courts adopted, is that the doctrine, which was developed judicially with the object of preserving a liquidated corporation's "earnings or profits" so that they might be taxed upon distribution as dividends, may be expanded in this case to transfer the deficits of the liquidated subsidiaries with the result that the accumulated earnings of the parent corporation otherwise available for distribution as dividends, vanished. It is the Government's view that adoption of this argument works a distortion of the *Sansome* principle.

A. *Application of the* Sansome *rule to permit a parent corporation to inherit the deficits of its subsidiaries runs counter to the purpose of that rule to prevent tax avoidance.*—In *Commissioner* v. *Munter*, 331 U. S. 210, this Court explained the reason for the *Sansome* rule as follows (pp. 214–216):

A basic principle of the income tax laws has long been that corporate earnings and profits should be taxed when they are distributed to the stockholders who own the distributing corporation. * * * Thus unless those earnings and profits accumulated by the predecessor corporations and undistributed in this reorganization are deemed to have been acquired by the successor corporation and taxable upon distribution by it, they would escape the taxation which Congress intended. * * *

In *Commissioner v. Sansome, supra,* it was held that implicit in the tax exemption of reorganization distributions was the understanding that the earnings and profits so exempt were acquired by the new corporation and were taxable as income to stockholders when subsequently distributed. * * *

* * * * *

The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part. Insofar as accumulated earnings and profits have been distributed contemporaneously with the reorganization so as to become taxable to the distributees, they, of course, cannot be said to have been acquired by the successor corporation. But insofar as payments to the predecessor corporations or their stockholders do not actually represent taxable distributions of

> earnings and profits, those earnings and profits must be deemed to have become available for taxable distribution by the successor corporation.

The purpose of the *Sansome* rule to prevent tax avoidance was recognized by the Court of Appeals for the Fifth Circuit in one of the earliest of the many cases that have applied the *Sansome* principle when, in *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641, 642, that court said:

> Unless the undistributed gains of the old business are taken over by the new as undivided profits distributable as dividends, they escape proper taxation.

And the matter was shortly put more recently when the Court of Appeals for the First Circuit said: "The purpose of the *Sansome* rule is to prevent tax evasion." *Putnam* v. *United States*, 149 F. 2d 721, 726. See also *Slover* v. *Commissioner*, 6 T. C. 884, 886.

That the origin and impelling reason for applying the *Sansome* rule is found in the necessity for obviating tax avoidance is forcefully high-lighted by the fact that where the liquidated corporation distributes a taxable dividend, covering its earnings, in the course of the reorganization, the rule has no application. *Commissioner* v. *Munter*, *supra*; *Campbell* v. *United States*, 144 F. 2d 177, 181–182 (C. C. A. 3d); *Slover* v. *Commissioner*, *supra*.

The reason for invoking the doctrine is absent where the liquidated corporation has a deficit. In such a case, there is no danger that a book capitalization of earnings will make possible an untaxed distribution of those earnings. Indeed, the extension of the *Sansome* rule to deficits would permit tax avoidance, the precise thing the rule was formulated to prevent. If, upon the acquisition of the assets of a corporation which formerly had a deficit, the acquiring corporation's earnings are treated as having been eliminated or reduced to the extent of the former deficit, the successor will be put in a position to distribute its own earnings to its stockholders without their being required to report them as taxable dividends as Section 115 (a) and (b) requires. This result would plainly frustrate the Congressional purpose, expressed in Section 115 (a) and (b), to tax distributions of corporate earnings or profits as they occur.[8] It cannot be justified by a doctrine the purpose of which was to prevent just such a result.

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[8] This circumvention of the Congressional purpose would occur in every case in which the liquidated corporation had a deficit which was treated as reducing the earnings of the acquiring corporation, and not merely in those cases in which the acquiring corporation purchased the stock of a deficit corporation for the express purpose of acquiring the deficit upon liquidation for tax avoidance purposes on the part of its stockholders. In the latter case, it might well be held, under the reasoning of *Gregory* v. *Helvering*, 293 U. S. 465, and *Bazley* v. *Commissioner*, 331 U. S. 737 (and cf. Section 129 of the Internal Revenue Code, as added by Section 128

Both lower courts in this case disregarded the underlying purpose of the *Sansome* rule and took the view (R. 22–23, 31–32) that the principle is equally applicable whether the liquidated corporation had accumulated earnings or a deficit, on the theory that in a tax-free transaction the corporate existence of the liquidated corporation is deemed to continue in the corporation which acquires its assets for all tax purposes. But the *Sansome* case, even taken alone and particularly when considered with the other decisions applying the same principle, does not support the statement of the Court of Appeals that in a liquidation or merger (R. 32)—

> * * * the entire corporate life survives as a continued venture insofar as tax consequences are concerned. A transaction of that kind does not produce any change in respect of tax purposes, the successor being merely the continuation of the predecessor. The principle is not a narrow one, limited to accumulated earnings or profits of the liquidated or absorbed company. * * *

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of the Revenue Act of 1943, c. 63, 58 Stat. 21 (26 U. S. C. 1946 ed. Sec. 129)), that the entire transaction had no substance and would be given no effect for tax purposes. Even so, it cannot be gainsaid that the decision below offers an additional incentive for attempts at tax avoidance by use of the reorganization provisions of the Internal Revenue Code and thus creates an additional risk of loss to the revenues.

The record in this case does not, of course, show whether the parent corporation acquired the stocks of the subsidiary companies before or after they had incurred their deficits, nor does it show the purpose of the acquisitions.

As Judge Huxman, dissenting, understood (R. 34), it has not been held that the oneness of identity continues for all tax purposes and in a situation where the reason for the *Sansome* rule ceases, it should no longer be given application.

In *Commissioner* v. *Sansome*, 60 F. 2d 931 (C. C. A. 2d), certiorari denied, 287 U. S. 667, Judge Learned Hand did refer to the fact that the reorganization there did not break the continuity of the corporate life, but that was not the basis of the decision. In the *Sansome* case, the new corporation could accurately be termed a continuation of the old corporation, since it continued in the same business with the same stockholders and assets. But as stated by the Second Circuit (p. 933), the basis of the decision was that Section 202 (c) (2) of the Revenue Act of 1921, c. 136, 42 Stat. 227 (which provided for the non-recognition of gain or loss on the exchange of stock or securities of one corporation for stock or securities in another corporation pursuant to a reorganization to which both corporations are parties), must be read as a gloss upon Section 201 of the Act (which defined a dividend as any distribution by a corporation out of its earnings or profits accumulated since February 28, 1913, and provided *inter alia* that every distribution is made from the most recently accumulated earnings or profits); and that, when so read, a reorganization from which gain or loss did not result did not "toll the company's life as a continued venture

under section 201" (Italics supplied) and therefore should not be treated for tax purposes as converting accumulated profits into capital. Hence, the decision was reached "as a matter of statutory construction" (p. 933) and the court treated the venture as continuing *only for purposes of Section 201, i. e.*, as continuing the accumulated profits as profits in the hands of the successor corporation.

This reading of the *Sansome* opinion is plainly confirmed by this Court's recent decision in *Commissioner* v. *Munter*, 331 U. S. 210. In that case, the Court of Appeals for the Third Circuit had, in reliance upon its previous decision in *Campbell* v. *United States*, 144 F. 2d 177, refused to apply the *Sansome* rule on the ground that, there not being an identity of proprietary interests in the predecessor and successor corporations, the continuity of corporate life had been broken. This Court squarely rejected that approach; as has been noted (*supra*, pp. 15–17), it held that the essence of the *Sansome* principle was the prevention of an untaxed distribution of earnings and that the lack of identity between the old and new corporations was of no consequence. This is an inescapable demonstration that the *Sansome* rule does not depend on a real or assumed oneness of corporate identity and consequent "continuity," a conclusion which had been foreshadowed not only by

the lower federal courts but by this Court itself.[8]

B. *The legislative and administrative confirmation of the principle announced in the* Sansome *case did not extend that principle to embrace the inheritance of deficits which, as a practical matter, are not transferred in the course of a reorganization or liquidation.*—Section 115 (h) of the Revenue Act of 1936 (Appendix, *infra*, pp. 70–71) provides in substance that distributions of stock or securities made by a corporation at any time shall not be considered a distribution of earnings or profits of any corporation, if no gain was recognized by law to the distributee on the receipt of the stock or securities, or if the distribution was a non-taxable stock dividend in the hands of the distributee. In recommending the section in the form in which it was enacted, the Senate Finance Committee said (S. Rep. No.

[7] *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1st); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Crocker* v. *Commissioner*, 29 B. T. A. 773.

[8] In *New Colonial Ice Co.* v. *Commissioner*, 66 F. 2d 480 (C. C. A. 2d), affirmed *sub nom. New Colonial Co.* v. *Helvering*, 292 U. S. 435, the court expressly pointed out (p. 482) that the *Sansome* case was limited to transactions falling within Sections 201 and 202. Both it and this Court held that a new corporation was a different entity from the old corporation, the assets of which the new corporation acquired in exchange for some of its stock which was distributed to the old company's stockholders; and that the new corporation could not carry over and deduct the old company's net losses for the preceding tax period under a statute which permitted a taxpayer to deduct a net loss for one year on his return for the succeeding taxable year.

2156, 74th Cong., 2d Sess., p. 19 (1939–1 Cum. Bull. (Part 2) 678, 690)):

SECTION 115 (H). EFFECT OF DISTRIBUTIONS ON EARNINGS AND PROFITS

The rule, under existing law, with respect to the effect on corporate earnings or profits of a distribution which, under the applicable tax law, is a nontaxable stock dividend or a distribution of stock or securities in connection with a reorganization or other exchange, *on which gain is not recognized in full, is that such earnings or profits are not diminished by such distribution. In such cases, earnings or profits remain intact and hence available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.* This rule is stated only in part in section 115 (h) of the Revenue Act of 1934, and corresponding provisions of prior acts, but is the rule which is applied by the Treasury and supported by the courts in *Commissioner* v. *Sansome* (60 Fed. (2d), 931); *United States* v. *Kauffman* (62 Fed. (2d), 1045); *Murchesson* v. *Comm.* (76 Fed. (2d), 641). While making no change in the rule as applied under existing law, the recommended amendment is desirable in the interest of greater clarity. [Italics supplied.]

The italicized part of this committee report was carried over substantially verbatim into Article 115–11 of Treasury Regulations 94 (Appendix, *infra*, p. 89), promulgated under the Revenue Act of 1936.

Section 115 (h) of the Revenue Act of 1938 (Appendix, *infra*, p. 71), amended the 1936 section so that it applied to distributions of "property or money" in addition to distributions of "stock or securities"[9] and as thus amended the secton was continued in the Internal Revenue Code as Section 115 (h) (26 U. S. C. 1946 ed., Sec. 115). Article 115–11 of Treasury Regulations 101 (Appendix, *infra*, pp. 89–91), promul-

[9] S. Rep. No. 1567, 75th Cong., 3d Sess., pp. 18–19 (1939–1 Cum. Bull. (Part 2) 779, 792), explained the amendment as follows:

"Under existing law, distributions of any property by a corporation which under the provisions of section 112 (b) or (c) are received by the shareholder without the recognition of gain to him (irrespective of what basis the property takes in the hands of such shareholder) are not regarded as being in any respect distributions of earnings or profits. Consequently, such earnings or profits remain unimpaired out of which taxable dividends may subsequently be declared either by the corporation making the distribution or by another corporation which, as to property acquired in an exchange described in section 112, takes in whole or in part the transferor's basis, so that the earnings or profits of the transferor corporation become in whole or in part the earnings or profits of such other corporation.

"In view of the fact that sections 112 (b) (6) and (7) permit the distribution of property (including money), in addition to stock or securities, without the recognition of gain to the distributee, appropriate changes are made in section 115 (h) of the House bill in the interest of added clarity."

gated under the Revenue Act of 1938, was amended to conform to this statutory change. The corresponding sections of subsequent Regulations were substantially the same.[10]

As this Court recognized in *Commissioner* v. *Munter*, 331 U. S. 210, 215, Section 115 (h) and the regulation both incorporate and follow the *Sansome* doctrine. The statute and the regulation, as well as the committee reports, quoted above, explaining the statute, refer only to "earnings or profits" and use the term in connection with amounts which are to be considered as available for distribution as dividends in the income tax sense following transactions of a non-taxable character. Obviously, in this context, there is no basis for an inference that the term was understood as including a deficit, since under Section 115 (a), a deficit is not a source for dividends.[11] Cf. *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717,

[10] Section 19.115–11 of Treasury Regulations 103 and Section 29.115–11 of Treasury Regulations 111, both promulgated under the Internal Revenue Code.

[11] The suggestion has been made that the term "earnings or profits" can be construed as referring to the "earned surplus account" and that in this sense it would include a negative balance (a deficit) in the account, as well as a positive balance, or earnings. But the statute, the regulation, and the committee reports were dealing with the earnings or profits available for dividends for tax purposes and were in no way concerned with the accounting aspect of the question. Moreover, it seems obvious that if the earned surplus account had been meant, that term would have been used.

where the court stated (p. 871) that Article 115–11 of Treasury Regulations 94 did not extend the rule to embrace operating deficits.

That Congress and the Treasury have made no mention of a deficit transfer in their discussions of the *Sansome* rule is not surprising in view of the practicalities of a reorganization or liquidation of a corporation with an operating deficit. Where a corporation has accumulated earnings or profits, they appear as such on the liability and net worth side of the balance sheet, but they are also represented by some part of the assets carried on the asset side of the balance sheet. The total assets together reflect and balance off the corporation's liabilities to creditors, its capital stock account, its paid-in surplus if any, and its accumulated earnings and profits. Stated another way, the total assets exceed the liability, capital stock, and capital surplus accounts in the amount of the accumulated earnings. Cf. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215. Hence, when such a corporation transfers all of its assets to a new or parent corporation, it necessarily transfers assets representing its accumulated earnings, and the acquiring corporation in fact receives the earnings in the form of property. The *Sansome* rule declares that for tax purposes these assets must retain their character as earnings in its hands instead of being capitalized, in order not to thwart the Congressional purpose that earn-

ings shall be taxed as dividends when distributed. *Commissioner* v. *Munter*, 331 U. S. 210.

On the other hand, where a corporation has a deficit instead of accumulated earnings or profits, none of its assets include or represent the deficit. The assets are less than its liabilities to creditors and to the holders of its capital stock; and to the extent of the deficit its capital is impaired. Cf. *United States* v. *Ogilvie Hardware Co.*, 330 U. S. 709, 711; *Willcuts* v. *Milton Dairy Co.*, *supra*. Consequently, the parent or successor corporation, upon acquisition of the assets, does not receive any assets which include or reflect the deficit; the assets received, to the extent that they are not subject to liabilities, reflect merely the capital stock. Thus, the acquiring corporation does not in fact acquire the deficit in any form. The deficit is the result of a reduction in, or loss of, assets in the past, and although the assets transferred upon the corporation's liquidation are less than they would have been had the liquidation taken place before the deficit was incurred, the assets actually transferred in liquidation are as of that date not reduced or affected in any way by the previously incurred deficits.

It follows that it would be illogical and unrealistic to treat the liquidated corporation's deficit as passing to the successor or parent corporation. Assets are transferred but, in contrast to the situation where the liquidated corporation had accumulated earnings, none of the assets reflect

the deficit. There is thus no factual basis for treating the transaction as though the acquiring corporation had taken over the deficit. Indeed, even for accounting purposes, a deficit is not regarded as transferred to a corporation which acquires the deficit corporation's assets,[12] although this, of course, is not controlling for federal tax purposes (*Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892).

Finally, as we have said, the *Sansome* rule is a device to prevent the earnings or profits of a predecessor, which are included in transferred assets, from being transformed into capital in the acquiring corporation's hands for taxable dividend purposes. But since in the case of a deficit corporation all of the net assets transferred by it already represent capital in its hands, there are actually no earnings upon which the *Sansome* rule can operate to prevent their transformation into capital.

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[12] To the extent that the assets received upon liquidation are less than the acquiring corporation's investment in the stock of the liquidated corporation, the former would sustain a loss, and for accounting purposes its earnings would be reduced by the *loss* on the liquidation. Although the operating deficit may be responsible wholly or in part for the loss, if any, the deficit itself, as such, would not reduce the earnings of the acquiring corporation. As will be shown, *infra*, pp. 29–40, for tax purposes as distinguished from accounting purposes, the loss is not permitted to reduce earnings and a reduction for the loss should not be allowed indirectly through subtraction of the former corporation's deficit.

C. *Application of the* Sansome *rule to permit the inheritance of a deficit would frustrate the explicit Congressional direction that unrecognized losses not reduce earnings.*—The capital account of a subsidiary corporation which has incurred a deficit as a result of its past operations is impaired in the amount of the deficit. Whether the impairment of capital as shown on the subsidiary's books will affect the parent corporation owning its stock depends on the amount of the parent's investment in the stock. If, upon liquidation of the subsidiary or other disposition of its stock, the parent receives assets of a lesser fair market value than its cost basis for the subsidiary's stock, it will suffer a loss to the extent of that difference. Section 111 (a) and (b), Revenue Act of 1936 (Appendix, *infra*, p. 68). But only if the parent's cost basis for the stock were exactly equal to the capital account as stated on the subsidiary's books and only if the value of the assets received by the parent were exactly equal to the value at which they were carried in computing the subsidiary's deficit, would the parent's loss correspond in amount to the deficit of the subsidiary. In most cases, the amounts of the deficit and the loss, if any, will not be the same, although both result from the subsidiary's previous unsuccessful operations. Such operations have produced a result, which from the standpoint of the subsidiary is a deficit,

and from the standpoint of the parent corporation may be a loss on its stock investment.

The record in this case does not show whether or not the parent corporation had a loss on the complete liquidation of any of the four subsidiaries. If losses were realized, however, they would not be recognized as deductible for tax purposes under Section 112 (b) (6) of the Revenue Act of 1936. And Article 115–3 of Treasury Regulations 94 (Appendix, *infra*, p. 87) states significantly that—

> Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section.

This regulation is reasonable and valid (see *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892), and its provisions were incorporated into the Internal Revenue Code as Section 115 (l) and made applicable to all prior years by Section 501 of the Second Revenue Act of 1940 (Appendix, *infra*, pp. 72–74). See also *Commissioner* v. *Fisher*, 327 U. S. 512.

Consequently, even if it is assumed without proof that the parent here had losses on the liquidation of the four subsidiaries which had deficits, its losses would not be permitted to reduce in any amount its earnings or profits for tax purposes, although they would perhaps do so

for bookkeeping purposes. Cf. *Commissioner* v. *Wheeler*, 324 U. S. at 546–547. And if the losses could not be used to eliminate the earnings, it would frustrate the legislative intention in that respect to permit a reduction of the parent's earnings by the subsidiaries' deficits. Thus, if the parent corporation had been granted the right by Congress to reduce its earnings by its loss on the liquidations, there could obviously be no contention that the deficits of the subsidiaries should also reduce its earnings. By the same token, to deduct the deficits is to substitute a compensating deduction for the deduction withheld by Congress and the regulation. The decision of the court below permitting the subsidiaries' deficits to wipe out the parent's accumulated earnings thus accomplishes indirectly that which is expressly prohibited by the regulation and the subsequently enacted statute.

The subsidiary's deficit *as such* should not reduce the parent's earnings, since the subsidiary's deficit is merely the measure from its viewpoint of its previous unprofitable operations; these operations are properly reflected, so far as the parent is concerned, only in the parent's loss. Thus, the attempt to deduct the subsidiaries' deficits from the parent's earnings, in circumvention of the legislative denial of the right to deduct the parent's own loss, is a wholly unwarranted confusion of the effect of the losing operations of the subsidiaries on the subsidiaries them-

selves with their separate and more indirect effect on the parent corporation. Cf. *New Colonial Co. v. Helvering*, 292 U. S. 435; *Interstate Transit Lines v. Commissioner*, 319 U. S. 590; *Moline Properties v. Commissioner*, 319 U. S. 436; *Commissioner v. National Carbide Corp.*, 167 F. 2d 304 (C. C. A. 2d), pending on certiorari, Nos. 151–153, this Term.

To reduce the parent's earnings by the subsidiaries' deficits is to assume, moreover, that the deficits must necessarily correspond in amount to the parent's actual loss. But this assumption is unwarranted, as has been shown, *supra*, pp. 29–30. As an example, the parent corporation may have purchased stock of a subsidiary, after all or a part of its deficit has been incurred, at a price equalling the value of the remaining assets. The parent would then sustain little or no loss on liquidation of the subsidiary, although the full deficit from the subsidiary's viewpoint would remain. In such circumstances, the writing down of the parent's earnings by the amount of the subsidiary's deficit would not only defeat the Congressional intention that the tax-free transaction is to have no effect on the parent's earnings or profits, but would also cause a disappearance of

[1] Cf. Section 129 of the Internal Revenue Code, as added by Section 128 of the Revenue Act of 1943, c. 63, 58 Stat. 21, which is applicable to years beginning after December 31, 1943, and which terms disallows a deduction, credit, or other allowance to a corporation or persons in circumstances where, for the principal purpose of securing a deduction,

the parent's earnings available for dividends in circumstances where its stockholders are not entitled to that advantage even as a matter of corporate accounting.[14]

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credit, or other allowance which it or they would not otherwise enjoy, the corporation or the persons acquire on or after October 8, 1940, directly or indirectly, property or control of another corporation not previously controlled by it or them and where the corporation's basis of the property is determined by reference to the basis in the hands of the transferor corporation. S. Rep. No. 627, 78th Cong., 1st Sess., pp. 58–61 (1944 Cum. Bull. 973, 1016–1018), explains this section in detail and indicates (pp. 60–61) that it would not apply in connection with a tax-free complete liquidation under Section 112 (b) (6) because, under such circumstances, there would not be an acquisition of control within the meaning of the section.

[14] It should be noted also that the parent corporation and its subsidiaries filed consolidated returns for the years 1918 to 1933, inclusive. (R. 12.) Although the stipulation does not show in what years the operating losses of the subsidiaries (which resulted in their deficits) were incurred and to what extent they were set off against the parent corporation's net income in the consolidated return years, it is a fair inference that the annual operating losses of the subsidiaries reduced the parent corporation's annual net income in some amount in those years.

The operating losses of the subsidiaries availed of by the parent corporation on consolidated returns were required to be subtracted by the parent corporation from its cost of the subsidiaries' stock in determining its adjusted basis for computing gain or loss on disposition of the stock under Article 113 (b)-1 of Treasury Regulations 94 (Appendix, *infra*, p. 87). The reduction of the parent corporation's basis by the operating losses of the subsidiaries so availed of may very well have represented a return to the parent corporation of the cost of the subsidiaries' stock in full and thus have resulted in its having no realized loss on liquidation of the subsidiary corporations in 1936. Cf. *Taylor-Wharton*

The view that the *Sansome* rule does not apply to deficits is not to be rejected because the treatment of losses would as a result differ somewhat from the treatment of gains realized on liquidation of a subsidiary corporation or on a statutory reorganization. To be sure, a gain to a parent corporation upon the liquidation of a subsidiary would not be recognized as includible in income under Section 112 (b) (6) and would not be reflected in the earnings account for tax purposes under Article 115–3 of Treasury Regulations 94 and Section 115 (l) of the Internal Revenue Code. Nevertheless, the *Sansome* rule operates in such case to transfer the accumulated earnings or profits of the subsidiary to the parent as earnings. The employment of this principle, limited to earnings or profits, does not, however, run counter to the Congressional intent, for in enacting Section 501 of the Second Revenue Act of 1940, which added Section 115 (l) to the Code, and which provides that unrecognized gains and losses are not to increase or decrease earnings or profits, the Congressional reports expressly stated that the *Sansome* rule was to operate in conjunction therewith. H. Rep. No. 2894, 76th Cong., 3d Sess., p. 41 (1940–2 Cum. Bull. 496, 526):

Iron & Steel Co. v. *Commissioner*, 5 T. C. 768, 781–782, which however, was concerned on those pages with a loss on liquidation of a subsidiary which was *recognized* under the law as it stood at the time and which therefore would reduce earnings or profits under Section 115 (l) of the Code.

S. Rep. No. 2114, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 528, 546–547). The reports refer to the rule as affecting earnings and profits only, and the absence of a corresponding reference to deficits is especially significant here. Section 501 dealt not only with gains but also with losses, and in correlating the *Sansome* rule with the section, the term "losses" would presumably have suggested to the Congressional committees the possibility of a deficit in the financial structure of the liquidating or transferor corporation, just as the term "gains" suggested earnings or profits in that connection. Congress' silence in respect of deficits here implies even more strongly than its general silence in this respect (see *supra*, pp. 22–28) that it regarded the *Sansome* rule as affecting only earnings or profits.

[15] The Senate Committee explained as follows (S. Rep. No. 2114, p. 25):

"Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the nonrecognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. These principles are to be given full effect under section 501. The requirement of section 501 that there shall be no increase or decrease in earnings and profits by reason of a wholly unrecognized gain or loss is but another aspect of the principle under which the earnings and profits of the transferor become by reason of the transfer the earnings and profits of the transferee."

Not only did Congress expressly indicate that the earnings of the liquidated subsidiary were to increase the earnings of the parent corporation, even though the gain on the liquidation was not recognized to the parent, but that result would be required in any case in order not to frustrate the direction of Section 115 (a) and (b) that corporate profits are to be taxed to the shareholders as dividends upon their distribution. *Commissioner* v. *Munter*, 331 U. S. 210. In contrast, Congress has given no indication that the deficit of a liquidated subsidiary is to reduce the accumulated earnings of the corporation which acquires its assets, nor is that reduction required to carry out the direction of Section 115 (a) and (b). As shown, to do so would defeat Section 115 (a) and (b).

Nor should the *Sansome* rule be enlarged to embrace deficits merely because there is a possibility that the parent corporation's accumulated earnings or profits may not in the future, for tax purposes, reflect fully the loss, if any, which the parent corporation sustained on the liquidations.[16] This possibility occurs as a result of the Congressional direction in Section 113 (a) (15) of the Revenue Act of 1936 (Appendix, *infra*, p. 69) that the parent corporation is to take, as its basis

[16] Earnings or profits in the tax sense do not necessarily follow corporate accounting concepts nor is there any requirement that they do so. See *Commissioner* v. *Wheeler*, 324 U. S. 542, 546, rehearing denied, 325 U. S. 892.

for computing gain or loss on sale or other disposition of the assets acquired from the subsidiaries, the basis of those assets in the hands of the subsidiaries.[17] To the extent that each subsidiary's cost basis for its assets, which the parent must use as its basis for those assets, varied from the parent's total investment in the stock of the subsidiary, the parent's gain or loss upon disposition of the assets will not reflect precisely the unrecognized loss it may have sustained at the time of liquidation upon the exchange of its stock investment for assets of a lesser value. Under Section 115 (l) of the Internal Revenue Code, the gain or loss at the time the assets are disposed of, if recognized, will be the amount by which the parent corporation's earnings or profits are then increased or decreased.

As already noted, the record in this case does not show that the parent corporation sustained a loss on liquidation of the subsidiaries. Furthermore, it does not appear that the basis of the assets in the hands of the parent corporation is different from its basis for the stock of the

[17] The subsidiaries' basis for the assets would of course be the actual cost of the assets to them under Section 113 (a), unless the assets had been acquired in a way which caused one of the exceptions to the general rule of Section 113 (a) to apply. The basis of each subsidiary for its assets was not necessarily correlated with its deficit. The basis for the assets on hand at the time of liquidation depended on the amount paid for the assets initially whereas the deficits resulted from the loss of other assets in operations. Cf. *Putnam* v. *United States*, 149 F. 2d 721, 726 (C. C. A. 1st).

subsidiaries surrendered in exchange for the assets. Hence, even under ordinary accounting concepts there is no factual basis here for reducing the parent corporation's earnings in 1936 by the deficits on the assumption that the earnings will not thereafter be reduced properly to reflect the loss sustained in 1936. But assuming for purposes of argument that both a loss and a difference in basis were proved, it is clear that, on the date of the liquidations, it could not be known whether or not the parent corporation would have a gain or loss upon the ultimate disposition of the assets in the future or, if it would have either gain or loss, the extent thereof. It follows that a reduction of the earnings by the subsidiary's deficit on the date of liquidation, on the theory that this adjustment will take account of a loss which can be reflected in no other way, may well reduce the earnings much more (or less) than the future events would warrant. As already shown, the subsidiary's deficit does not necessarily correspond in amount to the parent's loss on liquidation.

Finally, the assumption that all of a corporation's losses must for tax purposes be deducted from its earnings or profits is not justified. It is well settled that whether and to what extent a deduction for a loss or other item is allowable is a matter of legislative grace. *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590, 593; *Deputy* v. *du Pont*, 308 U. S. 488, 493;

White v. *United States*, 305 U. S. 281; *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440. It follows that Congress is not obliged to grant a deduction for any particular loss in determining taxable income, except perhaps where not to do so would result in subjecting capital to the income tax. It is reasonable to apply the same rule to the determination for tax purposes of the accumulated earnings or profits which are available for dividends. *Commissioner* v. *Wheeler*, 324 U. S. at 546. The parent corporation therefore would have no ground for complaint, even though the loss sustained by it on the liquidations is never fully deductible and is never fully reflected in its computation of earnings or profits for tax purposes.

A stockholder, rather than the corporation, is the taxpayer in this case, however. The stockholders stand in a different position from their corporation. Any actual losses sustained by their corporation upon the liquidations would be reflected in its balance sheet and would have their effect on the value of its stock. Thus, when the stockholders dispose of their stock, the price which they receive will reflect the corporation's losses; the effect of such a reflection of losses will be to reduce the stockholder's capital gain if his basis is smaller than the amount realized on disposition, or to permit the stockholder a capital loss allowance if his basis is greater than the amount realized. Thus it does not appear in this case, and

it could not be shown that taxation of the distribution from the parent corporation's earnings or profits, unreduced by the subsidiaries' deficits, to its stockholders will operate to prevent them from ever having their total capital investment in the stock of the parent corporation recognized as being free from income tax. They would have grounds for complaint only if this were true. Cf. *Commissioner* v. *Sansome, supra*, 60 F. 2d at 932; Paul, *Selected Studies in Federal Taxation* (Second Series), pp. 151–152, 166; 1 Mertens, *Law of Federal Income Taxation*, Secs. 5.06 and 9.29, pp. 171, 460–461.

D. *The reading put upon the* Sansome *rule by the court below finds no support in prior decisions.*—Although the rule of the *Sansome* case has been applied in the federal courts and has been the subject of litigation in those courts for more than sixteen years, never before has that rule been held to apply to permit an operating deficit of a predecessor corporation to wipe out the successor's accumulated earnings and profits.

The only previous decision directly concerned with the deficit of a liquidated corporation which transferred its assets to another corporation tax-free held that the deficit did not pass as a deficit to the succeeding corporation. In *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717, pursuant to tax-free complete liquidations in 1936, a parent corporation acquired the net assets of three wholly owned

subsidiary corporations, which together had an aggregate operating deficit of $1,205,451.61. Later in 1936, the parent made a distribution of $1 per share to its stockholders, totalling $937,743.[18] The parent's current earnings for the year 1936 were $931,553.82 and its accumulated earnings at the beginning of that year were $139,631.26. The taxpayer's contention was that, under the *Sansome* rule, the aggregate operating deficit of the subsidiaries, or alternatively, the losses sustained by the parent on the liquidations (which exceeded the total of the deficits by a small amount), eliminated the current earnings of the parent for 1936 and also part of its accumulated earnings at the beginning of the year, with the result that only a small part of the distribution in 1936 was a taxable dividend[19] under Section

[18] Although the court's opinion did not state the number of shares of the parent's stock which were outstanding at the time of the distribution, as the Tax Court noted (R. 22), the record in the case, which was before this Court on petition for a writ of certiorari, showed (R. 38, No. 85, 1945 Term) that the shares outstanding throughout 1936 were 937,743, on which four cash distributions of 25 cents per share each were made in 1936.

[19] The complaint alleged that $432 of the distribution of $450 to the taxpayer in 1936 was a capital distribution (R. 10–11, No. 85, 1945 Term), but the failure to claim that the remaining $18 was from capital was not because the taxpayer conceded that the parent's accumulated earnings at the beginning of the year 1936 remained undisturbed by the subsidiaries' deficits and a source for dividend payments. Rather his position was that the $139,631.26 of accumulated earnings as of January 1, 1936, should be reduced by the net loss for the year 1936 (subsidiaries' deficit of $1,205,451.61

115 (a) and (b) of the Revenue Act of 1936. The Court of Appeals for the Ninth Circuit held that the entire distribution in 1936 was a taxable dividend, deciding first that the parent's earnings of $931,553.82 for 1936 were not extinguished by either the deficits of, or the losses on liquidation of, the subsidiaries, and second that the accumulated earnings of the parent at the beginning of 1936 were likewise not erased by the deficits of, or the losses on liquidation of, the subsidiaries. The latter holding was expressed in the final paragraph of the court's opinion, where it said (p. 872):

> It being admitted that $931,553.82 earnings or profits were made in 1936 by the parent corporation and besides it had on hand undistributed profits of $139,631.26, the total amount exceeding that distributed to the stockholders, they were held properly by the tax court [sic] to be taxable as

minus parent's 1936 earnings of $931,553.82, or $273,897.79) prorated on a daily basis to March 14, 1936, the date of the payment of the first of the four 25-cent distributions, and that the remainder of the accumulated earnings (about $82,500) would be available for the payment of that dividend. (Pet. 6, fn. 2, No. 85, 1945 Term.) The contention was therefore that the deficits applied first to diminish current year's earnings and, that the excess of the deficits over current earnings became an operating loss of the parent for the year in which the liquidation occurred, which applied against and reduced the accumulated earnings to the extent that the loss could be assumed to have been incurred on the date the distribution was made. The Ninth Circuit's decision rejected this contention in its entirety.

> dividends to the distributees, of which the appellant is one. * * *

Whether or not the court's opinion is regarded as explaining its decision fully, the court unquestionably held that the entire distribution was a taxable dividend; it therefore necessarily decided that the accumulated earnings, as well as the current earnings, were not eliminated or reduced by the subsidiaries' deficits under the *Sansome* doctrine, since the current earnings for 1936 were insufficient alone (to the extent of $6,189.18) to cover the entire distribution. This holding with respect to the accumulated earnings was reaffirmed in a subsequent case involving a distribution by the parent corporation in 1938. *Cranson* v. *United States* (N. D. Cal.), decided November 12, 1943 (32 A. F. T. R. 1640), affirmed *per curiam*, 151 F. 2d 1021 (C. C. A. 9th).[20]

[20] The parent again distributed $937,743 in 1938, a year in which its current earnings or profits were only $695,694.64. The excess ($242,048.36) of the distribution over current earnings represented a taxable dividend only if the parent's accumulated earnings survived intact and unreduced after the 1936 transaction in which it had liquidated the three subsidiaries having deficits. The district court held that the deficits of the subsidiaries as of the date of their liquidation in 1936 did not diminish the parent's earnings or profits otherwise available for distribution to its stockholders during 1938, and this was affirmed *per curiam* on appeal pursuant to stipulation that the final decision in *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied, 326 U. S. 717, would be controlling. The district court's holding in this case necessarily applied exclusively to the parent's accumulated earnings, because it could not have been con-

Contrary to the views of both lower courts in the present case (R. 21–22, 32), the *Cranson* cases therefore did decide that the operating deficits of subsidiary corporations completely liquidated in 1936 in a tax-free transaction did not destroy the parent corporation's own accumulated earnings as of the date of the liquidation for taxable dividend purposes. The *Cranson* cases involved facts and circumstances substantially identical to those in this case and they affirmatively support our view that a deficit is not transferred under the *Sansome* doctrine. As previously stated, no other case has applied the *Sansome* rule to transfer a deficit.

Harter v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d), on which both lower courts relied (R. 17–19, 32), presented the typical *Sansome* factual situation in which corporations acquired the assets of predecessor corporations which had accumulated earnings or profits. The *Harter* opinion in fact dealt with two typical *Sansome* transactions. First, a new company acquired the assets of two old companies in a tax-free reorganization and it was held that the new company inherited the accumulated earnings of the old companies as earn-

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tended on any theory that the current earnings for 1938, which under Section 115 (a) were an independent source for payment of dividends irrespective of whether or not the corporation had accumulated earnings, were eliminated by the deficits or losses sustained on liquidations occurring two years before 1938.

ings under the *Sansome* principle. Later, in 1926, the new company was merged into the Boxboard Company, an existing corporation, which had a deficit of $17,388.95. It was again held that the Boxboard Company, which acquired the assets of the new company, also acquired its accumulated earnings as earnings. As the court pointed out (p. 13), the new company, prior to the merger, had accumulated earnings or profits acquired from the old companies of $2,085,587.78, and these carried over as earnings in the consolidation with Boxboard and remained earnings in Boxboard's hands. This left Boxboard with accumulated earnings of $2,068,198.83 ($2,085,587.78 minus Boxboard's deficit of $17,388.95), available to pay dividends to its stockholders.

Thus, the *Harter* case merely reiterates the *Sansome* rule that the accumulated earnings of a corporation are transferred as earnings to the corporation which acquires all of its assets in a statutory reorganization. It is not authority for and there is no dictum in the opinion supporting, the view that a corporation acquiring the assets of another company will be permitted to treat that other company's deficit as its own in reduction of its own accumulated earnings.

The Tax Court in this case (R. 18–19) pointed to the fact that, in the *Harter* case, Boxboard's own deficit was subtracted from the earnings

acquired from the predecessor,[21] but it failed to observe that this was not a step in determining whether the *Sansome* principle operated in that case to transfer the earnings; it was done only for the purpose of determining the *amount* of the accumulated earnings available for distribution as dividends by Boxboard, *after* it had been held that the predecessor's earnings had been received as earnings by Boxboard under the *Sansome* rule.

[21] As previously pointed out (fn. 2, p. 11, *supra*), prior to Section 115 (a) of the Revenue Act of 1936, which first established the current year's earnings as an independent source for dividends, only the earnings accumulated after February 28, 1913, were for tax purposes regarded as a source from which taxable dividends could be paid. In transactions occurring prior to 1936, it is the settled rule that where a corporation, such as Boxboard, had a deficit in its earned surplus account caused by operating losses, the deficit must have been restored in its entirety by applying against the deficit earnings received subsequently, before any of the subsequent earnings might be considered as accumulated earnings and available for distribution as a taxable dividend. Stated another way, the subsequent earnings were not available for dividend purposes, so long as an operating deficit existed. *Van Norman Co.* v. *Welch*, 141 F. 2d 99 (C. C. A. 1st); *Foley Securities Corp.* v. *Commissioner*, 106 F. 2d 731 (C. C. A. 8th); *Commissioner* v. *W. S. Farish & Co.*, 104 F. 2d 833 (C. C. A. 5th); *Sale* v. *Commissioner*, 35 B. T. A. 938, 939; 1 Mertens, *Law of Federal Income Taxation*, Section 9.30; cf. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215. *Contra* is *Blair* v. *United States*, 63 C. Cls. 193, certiorari denied, 275 U. S. 546, which was disapproved in the *Sale* case, *supra*. And compare *Pembroke Realty & S. Corp.* v. *Commissioner*, 122 F. 2d 252 (C. C. A. 2d), with *Brooklyn National Corp.* v. *Commissioner*, 157 F. 2d 450 (C. C. A. 2d), certiorari denied, 329 U. S. 733.

In the *Harter* case the events and distributions occurred long prior to 1936, and it was therefore necessary for the court

In the present case, the issue is whether the *Sansome* doctrine applies to transfer the deficits of the subsidiaries to the parent corporation as deficits, and this question is not resolved by the *Harter* case which applied the principle only to transfer earnings. Not until it had first been determined that the *Sansome* rule does transfer the deficits would there be occasion to apply the rule of the second step involved in the *Harter* case, that of combining the acquired deficits with the already existing earnings for purposes of determining the amount of accumulated earnings available for dividend purposes. It follows that the *Harter* decision does not lend any support to the judgment of the Court of Appeals in this case, as Judge Huxman, dissenting, pointed out (R. 35–36).

Nor did *Senior Investment Corp.* v. *Commissioner*, 2 T. C. 124, petition for review dismissed February 5, 1947 (C. C. A. 6th), to which the Tax Court referred (R. 19–20), decide the question as to whether the *Sansome* rule is to be extended to deficits. One question there was whether the taxpayer corporation had a deficit in accumulated earnings or profits at the beginning of the tax year, with the result that it was entitled to a

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to apply the earnings received by Boxboard as the acquiring corporation under the *Sansome* rule, first to restore Boxboard's own deficit, and to determine that only the excess of the acquired earnings over Boxboard's deficit represented the accumulated earnings in its hands available for dividend purposes.

deficit credit against income for purposes of computing its surtax on undistributed profits under Section 26 (c) (3) of the Revenue Act of 1936, as added by Section 501 (a) (2) of the Revenue Act of 1942, c. 619, 56 Stat. 798. Prior to the tax year it had transferred a part only of its assets to another company in a reorganization at a time when, as it contended, it had a deficit. Both parties agreed that, if it had a deficit at such time, the deficit was divisible between the two corporations, and the only issue was as to the method of division. Hence, the Tax Court was not required to decide whether a transferee corporation inherits the transferor's deficit in a reorganization. The case was concerned only with the amount of the deficit retained by the transferor after it had disposed of some of its assets.

The Tax Court also cited *Mandel* v. *Commissioner*, 5 T. C. 684 (R. 20–21), but that case is not apposite; it was concerned with the apportionment of the accumulated earnings of the old company as between it and a new company which acquired some of its assets; the earnings apportioned to the new company were of course held to be carried over intact to it under the *Sansome* rule.

And, finally, although in *Crocker* v. *Commissioner*, 29 B. T. A. 773, it was assumed without proof that one of three predecessor corporations, the assets of which were transferred to a successor

corporation in a tax-free reorganization, may have had a deficit, nevertheless, since the combined surplus of the three predecessors together was stipulated to be in excess of the distribution in question made by the successor corporation, it was held that the distribution was a taxable dividend. The case did not undertake to decide whether or not the assumed deficit of the one predecessor would have reduced the accumulated earnings of the successor corporation or the earnings of the other predecessors acquired as such under the *Sansome* principle by the successor.

E. *The decision of the court below is squarely in conflict with the Congressional assumption as to the scope of the* Sansome *rule as evidenced in the statutory provisions dealing with the computation of equity invested capital for excess profits tax purposes.*—Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, added a new subchapter to the Internal Revenue Code imposing a graduated surtax on excess profits, *i. e.*, profits in excess of normal profits, of corporations commencing with the year 1940.[22] One measure of the normal profits was a figure equal to a stated percentage of the "invested capital", which was allowed as a credit in arriving at the income subject to excess profits tax. Sections 710, 711, 712,

[22] Section 122 (a) of the Revenue Act of 1945, c. 453, 59 Stat. 556, provided that the provisions of the excess profits subchapter should not apply to taxable years beginning after December 31, 1945.

and 714 of the Code (26 U. S. C. 1946 ed., Secs. 710, 711, 712, and 714). Invested capital, for purposes of computing the allowable credit, was composed of "borrowed invested capital" and "equity invested capital". Section 717 (26 U. S. C. 1946 ed., Sec. 717.) See *Commissioner* v. *South Texas Co.*, 333 U. S. 496.

Section 718 (a) of the Code (Appendix, *infra*, pp. 74–76), as originally enacted in 1940, defined "equity invested capital" as the sum of (1) the money previously paid in for stock, or as paid-in surplus, or as a contribution to capital; (2) property previously paid in for stock, or as paid-in surplus, or as a contribution to capital, such property to be included in an amount equal to its unadjusted basis for determining loss upon sale or exchange; (3) previous distributions of stock which were considered distributions of earnings or profits; (4) the accumulated earnings or profits at the beginning of the year; and (5) the amount by which the aggregate of the money and the adjusted basis of property received in a non-taxable complete liquidation of a subsidiary corporation exceeded the aggregate of the parent's adjusted basis of the stock in the subsidiary and the liabilities it assumed. The sum of these amounts was to be reduced by the sum of the amounts described in Section 718 (b), Appendix, *infra*, pp. 76–78. These consisted of (1) and (2) previous distributions not out of earnings and profits; (3) the earnings and profits of another corporation which

had previously been included in the taxpayer's accumulated earnings and profits under the *Sansome* rule or by reason of a transfer by the other corporation to the taxpayer corporation of property, the basis of which, in the hands of the taxpayer, is determined by its basis in the former corporation's hands; and (4) the amount by which the aggregate of the taxpayer's adjusted basis for stock in a subsidiary corporation, previously liquidated by it in a tax-free liquidation, and the liabilities of the subsidiary which were assumed in the liquidation, exceeded the aggregate of the money and the adjusted basis of the subsidiary's property received in the liquidation (the amount of this reduction was not to exceed the accumulated earnings and profits at the beginning of the taxable year).

These provisions, as well as the later amendments, were, as we shall show, drafted on the assumption that the accumulated earnings and profits as of the beginning of the taxable year, which are to be included in invested capital under Section 718 (a) (4), would not, under the *Sansome* rule, have been reduced by the deficit of another corporation previously liquidated in a tax-free transaction. If, contrary to the legislative understanding, the *Sansome* rule is held to apply to a deficit, a distortion of the amount of equity invested capital under Section 718 will, in every case in which the assets of a deficit corporation have previously been acquired in a tax-free trans-

action, result. This distortion would seriously affect the structure of the excess profits tax, since "equity invested capital" is often a basic element in the computation of that tax. The Congressional understanding in this field of taxation thus has a twofold importance: it bears directly on the correctness of the decision below, and, collaterally, gives cause for serious concern lest a basic factor in the excess profits tax system be distorted by an inconsistent judicial interpretation.

1. In Section 718 (b) (3), Congress expressly provided for a reduction of equity invested capital by the earnings and profits of another corporation which previously had been included in the taxpayer's accumulated earnings or profits by reason of a non-taxable transaction described in Section 112 (b) to (e), inclusive, or by reason of a transfer by the other corporation to the taxpayer corporation of property, the basis of which in the hands of the taxpayer is determined by reference to its basis in the former corporation's hands. The purpose of this section, as explained in the committee reports, was to avoid a duplication in the computation of the taxpayer's invested capital by reason of the double inclusion therein of the earnings or profits of the previous corporation. H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 496, 514); S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 6, 14 (1940-2 Cum. Bull. 528, 532, 539); H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940-2 Cum.

Bull. 548, 555). The duplication referred to in the reports is, in the case of a tax-free reorganization, that resulting from the inclusion in invested capital of the former corporation's earnings or profits under the provisions of both Section 718 (a) (2) and Section 718 (a) (4). Thus, where the taxpayer corporation in exchange for its stock had previously acquired the assets of another corporation in a tax-free reorganization, any earnings or profits represented by those assets would have been transferred under the *Sansome* rule to the taxpayer corporation, would be reflected in the amount of its accumulated earnings and profits at the beginning of the taxable year, and would, therefore, be includible in its invested capital under Section 718 (a) (4). Furthermore, in these circumstances, the basis for the assets in the previous corporation's hands would have carried over to become the corporation's basis for the assets and, under Section 718 (a) (2), the transferred earnings of the previous corporation would again be reflected in the taxpayer's invested capital as a part of the assets paid in for stock, the old basis for the assets being treated as the amount paid in under that section.[23] The effect of Section

[23] The Congressional understanding seems to have been that accumulated earnings and profits or a deficit in the earnings account would be reflected in the transferor's adjusted basis. H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940-2 Cum. Bull. 496, 514). And see S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 193-194 (1942-2 Cum. Bull. 504, 646) quoted *infra*, fn. 29, pp. 63-64).

718 (b) (3) is to reduce invested capital in the amount by which, under the *Sansome* rule, the earnings or profits of the predecessor corporation would be reflected in the taxpayer corporation's accumulated earnings for purposes of Section 718 (a) (4). Cf. *Crossett Western Co.* v. *Commissioner*, 155 F. 2d 433 (C. C. A. 3d), certiorari denied, 329 U. S. 729.[24]

If the former reorganized corporation had had a deficit, instead of earnings or profits, and if the *Sansome* rule had operated to transfer the deficit to the taxpayer corporation, Congress would have been faced with the same problem of duplication in equity invested capital, as in the case of earnings. The former corporation's basis for the assets acquired would reflect its deficit and since this basis would be the amount at which the assets would be includible in invested capital under Section 718 (a) (2), the deficit would be reflected in the amount includible under that section as property paid in for stock. If the deficit had been inherited by the taxpayer corporation under the *Sansome* rule,

[24] In the *Crossett Western* case, it was held that the invested capital must be reduced under Section 718 (b) (3) by the amount of the earnings and profits of predecessor corporations which, under the *Sansome* rule, had in a previous year been included in the taxpayer corporation's earnings or profits, even though the subsequent operations of the taxpayer corporation had resulted in losses which wiped out the earnings acquired from the predecessor corporations so that at the beginning of the taxable year, the taxpayer corporation had a deficit in its earned surplus account.

the deficit would have reduced the taxpayer corporation's accumulated earnings; the deficit, consequently, would also be reflected in the amount of the earnings includible in invested capital under Section 718 (a) (4). To eliminate this double reflection of the deficit in invested capital, a special provision would have been necessary, by analogy to Section 718 (b) (3), increasing equity invested capital by the amount of the deficit previously deducted from the taxpayer's accumulated earnings. Congress did not, however, in 1940 (but see the discussion of Section 718 (a) (7) added in 1942 in point 3, *infra*, pp. 62–66) provide for an increase of invested capital to correspond to the amount of the reorganized corporation's deficit, which it would be expected to have done if it had understood or assumed that the *Sansome* rule applied to transfer deficits. The failure to include a provision designed to eliminate the double inclusion of the former corporation's deficit in invested capital under Section 718 (a) (2) and (4), which would result if the *Sansome* rule had transferred the deficits, is a clear indication that Congress did not regard the *Sansome* rule as applying to transfer to the taxpayer corporation the deficit of a former corporation.

Congress' assumption that the *Sansome* doctrine did not apply to deficits is all the more evident from the fact that, in drafting the legislation, Congress was expressly concerned with

deficit corporations as well as with those which had earnings. Congress recognized that the taxpayer corporation might have a deficit, rather than accumulated earnings at the beginning of the tax year, but it did not allow invested capital to be reduced by the deficit under Section 718 (a) (4); on the contrary, that section directs that only the accumulated earnings or profits as of the beginning of the taxable year (as distinguished from a deficit) shall be included in invested capital.[25] Since the possibility that the taxpayer corporation would have a deficit was recognized, it seems reasonable to infer that the same possibility in the case of a predecessor corporation also occurred to the legislators. In these circumstances, the failure to include a provision, similar to Section 718 (b) (3), for increase of invested capital by the amount of the deficit of a predecessor corporation previously deducted from accumulated earnings of the taxpayer derives added significance.

Furthermore, it seems plain that if the tax-

[25] H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 496, 514), stated, in connection with Section 718 (a) (4), that a deficit in accumulated earnings or profits at the beginning of the year shall not be taken into account but the earnings at that time shall be *zero* for purposes of computing the equity invested capital. Section 30.718–2 of Treasury Regulations 109, relating to the Excess Profits Tax under the Internal Revenue Code, incorporated this language and provided also that subsequent earnings and profits shall be applied to restore the deficit. This is in line with the general rule for income tax purposes. Fn. 21, pp. 46–47, *supra*.

payer corporation's own deficit at the beginning of the tax year could not reduce its invested capital as H. Rep. No. 2894, fn. 25, p. 56, *supra*, indicates, Congress would hardly have conceived that a deficit of a corporation previously liquidated could do so by means of the reduction of the taxpayer's accumulated earnings under the *Sansome* rule in a prior year.

2. The provisions of Section 718 (a) (5) and (b) (4) establish that Congress understood that the deficits of corporations previously completely liquidated tax-free under Section 112 (b) (6) were not transferred as such under the *Sansome* principle.

In the case where the taxpayer corporation had liquidated a subsidiary, the money and property originally paid in for the taxpayer's stock, to be included under Section 718 (a) (1) and (2), would not be affected by the transaction, as they would be in the case of a reorganization where stock is issued directly for property. Nevertheless, under Section 113 (a) (15) of the Internal Revenue Code, for income tax purposes, the taxpayer would be required to take as its basis for the assets acquired in the liquidation the basis of the assets in the subsidiary's hands. Congress was of course aware in 1940 that the former corporation's basis for such assets would not necessarily correspond to the taxpayer corporation's former investment in the stock of the liquidated corporation; and that, to the ex-

tent of the difference between its investment in the liquidated corporation and the former corporation's basis of the assets received in exchange for its investment on the liquidation, the taxpayer corporation would have realized a gain or loss on the liquidation of the other corporation which, however, was not recognized for income tax purposes at that time and would not be reflected in its accumulated earnings or profits at the beginning of the tax year. Since the accumulated earnings to be included in invested capital under Section 718 (a) (4) would not reflect the gain or loss on the previous liquidation, Congress recognized that an adjustment was necessary. Accordingly, it provided in Section 718 (a) (5) and (b) (4) for an adjustment of invested capital in the case of a tax-free complete liquidation of a former subsidiary, which would substitute the subsidiary's adjusted basis for the assets in place of the corporation's adjusted basis for the subsidiary's stock surrendered in exchange for the assets.[26] The effect of this adjustment is

[26] Section 718 (a) (5) and (b) (4) were inserted in conference. H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940–2 Cum. Bull. 548, 555), stated with respect to them:

"The conference agreement also makes further technical changes in order to eliminate duplications in the computation of equity invested capital. Provisions have been inserted governing the extent to which the equity invested capital of a parent corporation is to be increased or decreased following a liquidation under section 112 (b) (6). This provision enables the provisions of section 718 (b) (3) to be

to recognize for invested capital purposes, although it is not recognized for income tax purposes under Section 113 (1), that part of the gain or loss to the taxpayer-parent corporation represented by the receipt of assets on liquidation at a basis greater or less than its basis for the stock in the subsidiary. Cf. *Taylor-Wharton Iron & Steel Co.* v. *Commissioner*, 5 T. C. 768, 784–785, in which the Tax Court stated (p. 785) that Section 718 (b) (4) requires a reduction of invested capital by the amount of a loss on liquidation of a subsidiary which is not recognized for income tax purposes.

If the deficit of a former subsidiary had carried over under the *Sansome* principle to reduce the corporation's accumulated earnings, the amount of the accumulated earnings at the beginning of the tax year, includible under Section 718 (a) (4) in invested capital, would reflect (although not always accurately, see *supra*, pp. 29–30, 32–33) the loss on the liquidation, and Section 718 (b) (4) would direct an adjustment for the same loss, thus duplicating the effect of the *Sansome* rule.[27] The

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expanded so as to cover all situations in which, under the doctrine of *Commissioner* v. *Sansome* (60 Fed. (2d), 931), the earnings and profits of one corporation become the earnings and profits of another. * * *"

[27] Our point may be clarified by an example: The invested capital of the A corporation is to be computed. The property paid in for its stock originally was $150,000. At the beginning of the year it has accumulated earnings of $50,000. Previously A had invested $100,000 in stock of B corporation, which it wholly owned. B had incurred an operating

inclusion of Section 718 (b) (4), the purpose of which was to eliminate duplications (fn. 26, pp. 58–59, *supra*), is clear evidence that Congress understood and assumed that the deficit of a liquidated subsidiary corporation would not reduce the parent's earnings under the *Sansome* rule, and that the *Sansome* doctrine was confined in its operation to earnings or profits (cf. fn. 26, pp. 58–59, *supra*).

This is confirmed by comparing the situation existing if the liquidated subsidiary had had accumulated earnings. Those earnings would of course have previously increased the parent's accumulated earnings under the *Sansome* rule and would be reflected in the accumulated earnings includible in invested capital under Section 718 (a) (4). And as in the deficit situation, the basis adjustment required by Section 718 (a) (5) to reflect the taxpayer corporation's gain on the liquidation would duplicate the *Sansome* increase

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deficit of $25,000 and its original assets of $100,000 had thereby shrunk to $75,000. Upon complete liquidation prior to the taxable year, A took over the B assets at a basis of $75,000. Thus, A's invested capital is $150,000 (Section 718 (a) (2)), plus $50,000, the accumulated earnings (Section 718 (a) (4)), reduced by the loss of $25,000 on the liquidation (Section 718 (b) (4)), or $175,000. If the B deficit of $25,000 had carried over to reduce A's accumulated earnings of $50,000 at the time of the liquidation, A's invested capital would be $150,000 (Section 718 (a) (2)), plus $25,000, the reduced accumulated earnings (Section 718 (a) (4)), minus $25,000, the loss on the liquidation (Section 718 (b) (4)), resulting in a final invested capital of only $150,000.

to the accumulated earnings, were it not for the fact that under Section 718 (b) (3), Congress expressly directed the subtraction of the subsidiary's earnings formerly included in the parent's earnings under the *Sansome* rule. In the deficit situation there is no section, corresponding to Section 718 (b) (3), which is designed to remove the duplication which would result if, under the *Sansome* rule, the deficit had been transferred into the parent's accumulated earnings account. The absence of a section, corresponding to Section 718 (b) (3), having for its purpose the prevention of a duplication in invested capital which would result from the reflection of the deficit of a liquidated corporation in the accumulated earnings at the beginning of the year includible under Section 718 (a) (4) (if the *Sansome* rule had transferred the deficit) and from the reflection of the loss on the liquidation taken into account by Section 718 (b) (4), is an additional indication that, within Congress' understanding and intention, the *Sansome* rule would not have transferred the deficit.[28]

[28] Section 230 (c) of the Revenue Act of 1942, c. 619, 56 Stat. 798, provided that Section 718 (a) (5) and (b) (4) should not apply to any taxable year beginning after December 31, 1941, but in place of these subsections, Section 230 (a) of the 1942 Act added Section 761 to the Internal Revenue Code. Section 761 (Appendix, *infra*, pp. 79-86) deals with transfers of property pursuant to tax-free intercorporate liquidations and provides for adjustments to invested capital, somewhat different from, and more complicated than, those made by Section 718 (a) (5) and (b) (4). The

3. By Section 219 of the Revenue Act of 1942, Congress added Section 718 (a) (7), (b) (5), and (c) (5) to the Internal Revenue Code (Appendix, *infra*, pp. 76, 78; 78–79) for application to taxable years beginning after December 31, 1939. These sections pertain to certain transfers of property by one corporation to another in exchange for the other's stock (and thus do not include a tax-free liquidation of subsidiaries of the kind involved in this case), and provide rules

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substance of Section 761 is that it adjusts invested capital of a taxpayer, by means of a plus or minus quantity (Section 761 (b) and (d)), in the amount of the difference between the taxpayer's adjusted basis for the stock in a subsidiary which has been liquidated, determined as directed, and the unadjusted basis of the assets in the hands of the subsidiary. The adjusted basis for those assets of a subsidiary attributable to such of the parent's stock as has a cost basis is determined (Section 761 (c) (1)) by substituting, as of the time the parent taxpayer acquired control of the subsidiary's stock or thereafter in certain circumstances, for the actual basis of the assets, the taxpayer's basis for the stock, and adjusting such basis thereafter to reflect the subsidiary's subsequent operations. For an explanation of Section 761 which was revised by the Senate Finance Committee, see S. Rep. No. 1631, 77th Cong., 2d Sess., pp. 222–228 (1942–2 Cum. Bull. 504, 667–671). Without discussing these complicated provisions in detail, suffice it to say that the adjustments there provided for, like the simpler and comparable adjustments directed by Section 718 (a) (5) and (b) (4), are believed, for the reasons given in connection with Section 718 (a) (5) and (b) (4), to have been drafted upon the basic assumption that the deficits of a liquidated subsidiary would not have been transferred under the *Sansome* rule to the parent corporation and would not be reflected in the parent's accumulated earnings, to be included in invested capital under Section 718 (a) (4).

for treatment of the transferor's deficit for invested capital purposes.

Section 718 (a) (7) requires the increase of the invested capital of the transferee (the corporation acquiring the former corporation's assets) by the portion of the transferor's deficit which is attributable to its property previously received by the transferee. This provision, standing alone, cannot be construed as assuming that under the *Sansome* rule the deficit had previously reduced the accumulated earnings of the transferee which would be included under Section 718 (a) (4), in view of the legislative explanation of the section.[29]

[29] S. Rep. No. 1631, 77th Cong., 2d sess., pp. 193–194 (1942–2 Cum. Bull. 504, 646), explained the provisions as follows:

"SECTION 218. DEFICIT IN EARNINGS AND PROFITS OF ANOTHER CORPORATION.

"This section is new, no corresponding section having appeared in the House bill. Under existing law an operating loss of a corporation can reduce its invested capital through accumulated earnings and profits but cannot reduce invested capital, if there are no earnings and profits, by being deducted from the money or property paid in to such corporation. Thus, although earnings and profits increase invested capital, deficits in earnings and profits do not decrease invested capital. Under section 751 of existing law, and under section 760 which has been inserted by this bill to amend section 751, for years beginning after December 31, 1941 (relating to invested capital in case of certain tax-free exchanges), invested capital of a "transferee," as defined in such sections, is computed by taking into account the adjusted basis for determining loss in the hands of the transferee of property received from the transferor. Any loss sustained by the transferor will be reflected in the invested capital of the transferee either in a reduced basis of assets received from the transferor or in a reduced amount of prop-

As the Senate Report points out (fn. 29, *supra*), any loss sustained by the transferor (*i. e.*, its deficit) would be reflected in the invested capital

erty which will be deemed to have been paid in for stock in case the transferor used borrowed funds to pay its losses, since such sections provide for a reduction in the amount of property deemed to be paid in for stock by the amount of indebtedness of the transferor. Thus, the so-called deficit rule is not applicable in the case of such tax-free exchanges and reorganizations.

"Your committee has amended section 718 to provide that in certain cases the invested capital of a transferee, which otherwise would reflect a deficit of the transferor, will be increased by the amount of such deficit and that the invested capital of the transferor will be correspondingly reduced. The rule increasing the invested capital of a corporation by the deficit of its transferor will apply only if * * *. If these factors are present, the invested capital of the transferee otherwise computed shall be increased, and the invested capital of the transferor shall be decreased by the deficit in earnings and profits of the transferor which is attributable to the property so transferred. It is necessary to insure, however, that the transferee shall be deemed to have a deficit in earnings and profits so that subsequent earnings shall first be reduced by the amount of such deficit before any earnings and profits can be determined to have been accumulated and to increase invested capital, and to insure that the deficit of the transferor (which has been transferred to the transferee) shall not continue at the old amount, but should be reduced by the amount so transferred. Your committee has therefore provided that in computing the equity invested capital for any day after the date of acquisition of the property, the earnings and profits or deficit in earnings and profits of the transferee and the transferor shall be computed as if, immediately before beginning of the taxable year in which such transfer occurs, the transferee had been in existence and sustained a recognized loss, and the transferor had realized a recognized gain, equal to that portion of the deficit in earnings and profits of the transferor which is attributable to the property so transferred."

of the transferee (under Section 718 (a) (2)) either in a reduced basis of assets received from the transferor or in a reduced amount of property paid in for stock and thus "the so-called deficit rule is not applicable in the case of such tax-free exchanges and reorganizations." This we understand to be a statement that the *Sansome* rule would not apply to transfer the transferor's deficit as a deficit. Even though the deficit would not be reflected in the transferee's accumulated earnings as a result of the *Sansome* rule, Section 718 (a) (7) was enacted, as the report states, to increase the invested capital of the transferee by the deficit in order to counteract the reduction of invested capital resulting from the reflection of the deficit in the amount of property paid in for stock under Section 718 (a) (2).

Furthermore, Section 718 (a) (7) was accompanied by Section 718 (c) (5), under which the increase to invested capital in the amount of the transferor's deficit made by Section 718 (a) (7) is compensated for by a corresponding decrease, either then or in the future, of the transferee's earnings which are includible in invested capital.

Section 718 (c) (5) provides that the earnings or profits of the transferee (which will be included in invested capital under Section 718 (a) (4)) are to be computed as if, immediately before the taxable year in which the assets were transferred, the transferee had sustained a recognized loss equal to the portion of the deficit attributable

to the property it received. In other words, under the express provisions of Section 718 (c) (5), the deficit of the transferor is treated as carrying over to the transferee corporation as a deficit and reducing its earnings, if any, as of such time, or if the transferee then had no earnings the deficit would be retained by it as a deficit and would have to be restored from future earnings, in determining whether or not the transferee had accumulated earnings or profits to be included in invested capital under Section 718 (a) (4) for that and subsequent years. To this limited extent, Section 718 (c) (5), by express enactment, extends the *Sansome* rule to transfer the deficits of certain former corporations to their successors intact. As Senate Report No. 1631 (fn. 29, p. 64, *supra*) shows, the purpose of Section 718 (c) (5) was to insure that the transferee's earned surplus account, for invested capital purposes, had been adjusted by the transferor's deficit. But if the *Sansome* rule were also operative to transfer the deficit, then Section 718 (c) (5) would duplicate the *Sansome* transfer, with the consequence that the transferee's accumulated earnings account would reflect two times the actual deficit of the transferor. This is a further recognition that the *Sansome* rule would not operate without legislative aid in the case of a deficit, and an equally plain indication that it was not to do so except in the circumstances painstakingly delimited in Section 718 (c) (5).

CONCLUSION

The judgment of the Court of Appeals is erroneous for the reasons given and should be reversed.

Respectfully submitted.

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APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of gain or loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of gain or loss.*—In the case of a sale or exchange, the extent to

which the gain or loss determined under this section shall be recognized for the purposes of this title, shall be determined under the provisions of section 112.

* * * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * * *

(6) *Property received by corporation on complete liquidation of another.*—No gain or loss shall be recognized upon the receipt by a corporation of property distributed in complete liquidation of another corporation. * * *

* * * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—

* * * * * *

(15) *Property received by a corporation on complete liquidation of another.*—If the property was received by a corporation upon a distribution in complete liquidation of another corporation within the meaning of section 112 (b) (6), then the basis shall be the same as it would be in the hands of the transferor.

* * * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of dividend.*—The term "dividend" when used in this title (except

in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. . . .

(b) *Source of distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in *another* corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * * *

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

* * * * * *

(h) *Effect on earnings and profits of distributions of stock.*—The distribution (whether before January 1, 1938, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities, of stock or securities in another corporation, or of property or money, shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities, property or money, was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * * *

Second Revenue Act of 1940, c. 757, 54 Stat. 974:

SEC. 501. EARNINGS AND PROFITS OF CORPORATIONS.

(a) *Under Internal Revenue Code.*—Section 115 of the Internal Revenue Code is amended by inserting at the end thereof the following new subsections:

"(l) *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

"(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

"(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. Where in determining the adjusted basis used in computing such gain

ized gain or loss the adjustment to the basis differs from the adjustment proper for the purpose of determining earnings or profits, then the latter adjustment shall be used in determining the increase or decrease above provided. Where a corporation receives (after February 28, 1913) a distribution from a second corporation which (under the law applicable to the year in which the distribution was made) was not a taxable dividend to the shareholders of the second corporation, the amount of such distribution shall not increase the earnings and profits of the first corporation in the following cases:

"(1) No such increase shall be made in respect of the part of such distribution which (under such law) is directly applied in reduction of the basis of the stock in respect of which the distribution was made.

"(2) No such increase shall be made if (under such law) the distribution causes the basis of the stock in respect of which the distribution was made to be allocated between such stock and the property received.

* * * * *

(b) *Effective date of amendment.*—The amendment made by subsection (a) shall be applicable to taxable years beginning after December 31, 1938.

(c) *Under prior acts.*—For the purposes of the Revenue Act of 1938 or any prior Revenue Act the amendments made to the Internal Revenue Code by subsection (a) of this section shall be effective as if they were a part of each such Revenue Act on the date of its enactment. Nothing in this subsection shall affect the tax liability of any taxpayer for any year which, on Sep-

tember 20, 1940, was pending before, or was theretofore determined by, the Board of Tax Appeals, or any court of the United States.

Internal Revenue Code:

SEC. 718 [added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798] *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section

115 (l) for determining earnings and profits;

(3) *Distributions in stock.*—Distributions in stock—

(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

(B) Previously made during such taxable year to the extent to which they are considered distributions of earnings and profits other than earnings and profits of such taxable years;

(4) *Earnings and profits at beginning of year.*—The accumulated earnings and profits as of the beginning of such taxable year;

(5) *Increase on account of gain on tax-free liquidation.*—In the case of the previous receipt of property (other than property described in the last sentence of section 113 (a) (15)) by the taxpayer in complete liquidation of another corporation under section 112 (b) (6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received, exceeds the sum of:

(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such

property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received;

* * * * *

(7) [added by Sec. 219 (a), Revenue Act of 1942, *supra*] *Deficit in earnings and profits of another corporation.*—In the case of a transferee, as defined in subsection (c) (5), an amount, determined under such paragraph, equal to the portion of the deficit in earnings and profits of a transferor attributable to property received previously to such day.

(b) *Reduction in Equity Invested Capital.*—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in previous years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

(2) *Distributions during the year.*—Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

(3) *Earnings and profits of another corporation.*—The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in section 112 (b) to (e), both inclusive, or in the corresponding provision of a prior revenue law, or by reason of the transfer by such other corporation to the taxpayer of property the basis of which in

the hands of the taxpayer is or was determined with reference to its basis in the hands of such other corporation, or would have been so determined if the property had been other than money; and

(4) *Reduction on account of loss on tax-free liquidation.*—In the case of the previous receipt of property (other than property described in the last sentence of section 113 (a) (15)) by the taxpayer in complete liquidation of another corporation under section 112 (b) (6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the sum of—

(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received,

exceeds the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received. The amount of the reduction under this paragraph shall not exceed the accumulated earnings and profits as of the beginning of such taxable year;

(5) [added by Sec. 219 (b), Revenue Act of 1942, *supra*] *Deficit in earnings and profit transferred to another corporation.*—In the case of a transferor, as defined in subsection (c) (5), an amount, determined under such paragraph, equal to the portion of the deficit in earnings and profits of the transferor attributable to property transferred previously to such day.

(c) *Rules for application of subsections (a) and (b).*—For the purposes of subsections (a) and (b)—

* * * * *

(3) [as amended by Sec. 202 (f), Revenue Act of 1941, c. 412, 55 Stat. 687] *Computation of earnings and profits of taxable year.*—For the purposes of subsections (a) (3) (B) and (b) (2) in determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the tax under this subchapter or chapter 1 for such year and the determination shall be made without regard to the amount of earnings and profits at the time the distribution was made.

* * * * *

(5) [added by Sec. 219 (c), Revenue Act of 1942, *supra*] *Deficit in earnings and profits—Earnings and profits of transferor and transferee.*—If a corporation (hereinafter called "transferor") transfers substantially all its property to another corporation formed to acquire such property (hereinafter called "transferee"), if—

(A) the sole consideration for the transfer of such property is the transfer to the

transferor or its shareholders of all the stock of all classes (except qualifying shares) of the transferee. (In determining whether the transfer is solely for stock, the assumption by the transferee of a liability of the transferor or the fact that the property acquired is subject to a liability shall be disregarded);

(B) the basis of the property, in the hands of the transferee, for the purposes of this subsection, is determined by reference to the basis of the property in the hands of the transferor;

(C) the transferor is forthwith completely liquidated in pursuance of the plan under which the acquisition of the property is made; and

(D) immediately after the liquidation the shareholders of the transferor own all such stock;

for the purposes of this subchapter, in computing the equity invested capital for any day after the date of the acquisition of the property, the earnings and profits or deficit in earnings and profits of the transferee and the transferor shall be computed as if, immediately before the beginning of the taxable year in which such transfer occurs, the transferee had been in existence and sustained a recognized loss, and the transferor had realized a recognized gain, equal to the portion of the deficit in earnings and profits of the transferor attributable to such property.

(26 U. S. C. 1946 ed., Sec. 718.)

SEC. 761 [added by Sec. 230 (a), Revenue Act of 1942, *supra*]. INVESTED CAPITAL ADJUSTMENT AT THE TIME OF TAX-FREE INTERCORPORATE LIQUIDATIONS.

(a) *Definition of intercorporate liquidation.*—As used in this section, the term "intercorporate liquidation" means the receipt (whether or not after December 31, 1941) by a corporation (hereinafter called the "transferee") of property in complete liquidation of another corporation (hereinafter called the "transferor") to which

(1) the provisions of section 112 (b) (6), or the corresponding provision of a prior revenue law, is applicable or

(2) a provision of law is applicable prescribing the non-recognition of gain or loss in whole or in part upon such receipt (including a provision of the regulations applicable to a consolidated income or excess profits tax return but not including section 112 (b) (7), (9), or (10) or a corresponding provision of a prior revenue law),

but only if none of such property so received is a stock or a security in a corporation the stock or securities of which are specified in the law applicable to the receipt of such property as stock or securities permitted to be received (or which would be permitted to be received if they were the sole consideration) without the recognition of gain.

(b) *Definition of plus adjustment and minus adjustment.*—For the purposes of this section—

(1) *Plus adjustment.*—The term "plus adjustment" means the amount, with respect to an intercorporate liquidation, determined to be equal to the amount by which the aggregate of the amount of money received by the transferee in such intercorporate liquidation, and of the adjusted basis at the time of such receipt of all

property (other than money) so received, exceeds the sum of—

(A) the aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determind immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) the aggregate of the liabilities of the transferor assumed by the transferee in connection with the receipt of such property, of the liabilities (not assumed by the transferee) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the transferee for such property so received.

(2) *Minus adjustment.*—The term "minus adjustment" means the amount, with respect to an intercorporate liquidation, determined to be equal to the amount by which the sum of—

(A) the aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

(B) the aggregate of the liabilities of the transferor assumed by the transferee in connection with the receipt of such property, of the liabilities (not assumed by the transferee) to which such property so received was subject; and of any other consideration (other than the stock with respect to which such property was received)

given by the transferee for such property so received

exceeds the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received.

(3) *Rules for application of paragraphs (1) and (2).*—In determining the plus adjustment or minus adjustment with respect to any share, the computation shall be made in the same manner as is prescribed in paragraphs (1) and (2) of this subsection, except that there shall be brought into account only that part of each item which is determined to be attributable to such share.

(c) *Rules for the application of this section.*—

(1) *Stock having cost basis.*—The property received by a transferee in an intercorporate liquidation attributable to a share of stock having in the hands of the transferee a basis determined to be a cost basis, shall be considered to have, for the purposes of subsection (b), an adjusted basis at the time so received determined as follows:

(A) The aggregate of the property (other than money) held by the transferor at the time of the acquisition by the transferee of control of the transferor (or, if such share was acquired after the acquisition of such control, at the time of the acquisition of such share, or, if such control was not acquired, at the time immediately prior to the receipt of any property in the intercorporate liquidation in respect of such share) shall be deemed to have an aggregate basis equal to the amount obtained by (i) multiplying the amount of the adjusted basis at such time of such

share in the hands of the transferee by the aggregate number of share units in the transferor at such time (the interest represented by such share being taken as the share unit), and (ii) adjusting for the amount of money on hand and the liabilities of the transferor at such time.

(B) The basis which property of the transferor is deemed to have under subparagraph (A) at the time therein specified shall be used in determining the basis of property subsequently acquired by the transferor the basis of which is determined with reference to the basis of property specified in subparagraph (A).

(C) The basis which property of the transferor is deemed to have under subparagraphs (A) and (B) at the time therein specified shall be used in determining all subsequent adjustments to the basis of such property.

(D) The property so received by the transferee shall be deemed to have, at the time of its receipt, the same basis it is deemed to have under the foregoing provisions of this paragraph in the hands of the transferor, or in the case of property not specified in subparagraph (A) or (B), the same basis it would have had in the hands of the transferor.

(E) Only such part of the aggregate property received by the transferee in the intercorporate liquidation as is attributable to such share shall be considered as having the adjusted basis which property is deemed to have under subparagraphs (A), (B), (C), and (D) of this paragraph.

(2) *Basis of stock not a cost basis.*—The property received by a transferee in an intercorporate liquidation attributable to a share of stock having in the hands of the

transferee a basis determined to be a basis other than a cost basis shall, for the purposes of subsection (b), be considered to have, at the time of its receipt, the basis it would have had had the first sentence of section 113 (a) (15) been applicable.

(3) *Definition of control.*—As used in this subsection, the term "control" means the ownership of stock possessing at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and the ownership of at least 80 per centum of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), but only if in both cases such ownership continues until the completion of the intercorporate liquidation.

(d) *Adjustment of equity invested capital.*—If property is received by the transferee in an intercorporate liquidation, in computing the equity invested capital of the transferee for any day following the completion of such intercorporate liquidation—

(1) with respect to any share of stock in the transferor having in the hands of the transferee, immediately prior to the receipt of any property in such intercorporate liquidation, a basis determined to be a cost basis, the earnings and profits or deficit in earnings and profits of the transferee shall be computed as if on the day following the completion of such intercorporate liquidation the transferee had realized a recognized gain equal to the amount of the plus adjustment in respect of such share, or had sustained a recognized loss equal to the amount of the minus adjustment in respect of such share;

(2) with respect to any share of stock in the transferor having in the hands of the transferee, immediately prior to the receipt of any property in such intercorporate liquidation, a basis determined to be a basis other than a cost basis, there shall be treated as an amount includible in the sum specified in section 718 (a) the amount of the plus adjustment with respect to such share, or as an amount includible in the sum specified in section 718 (b) the amount of the minus adjustment with respect to such share.

(e) *Invested capital basis.*—The adjusted basis which property received by the transferee in an intercorporate liquidation is considered to have under the provisions of subsection (c) at the time of its receipt shall be thereafter treated as the adjusted basis, in lieu of the adjusted basis otherwise prescribed, in computing any amount, determined by reference to the basis of such property in the hands of the transferee, entering into the computation of the invested capital of the transferee, or of any other corporation the computation of the invested capital of which is determined by reference to the basis of such property in the hands of the transferee.

(f) *Statutory mergers and consolidations.*—If a corporation owns stock in another corporation and such corporations are merged or consolidated in a statutory merger or consolidation, then for the purposes of this section and section 718 such stock shall be considered to have been acquired (in such statutory merger or consolidation) by the corporation resulting from the statutory merger or consolidation, and the properties of such other corporation attributable to such stock to have been re-

ceived by such resulting corporation as a transferee from such other corporation as a transferor in an intercorporate liquidation.

(g) *Determinations.*—

(1) *Regulations.*—Any determination which is required to be made under this section (including determinations in applying this section in cases where there is a series of transferees of the property and cases where the stock of the transferor is acquired by the transferee from another corporation, and the determinations of the basis and adjusted basis which property or items thereof have or are considered to have) shall be made in accordance with regulations which shall be prescribed by the Commissioner with the approval of the Secretary. If the transferor or the transferee is a foreign corporation, the provisions of this section shall apply to such extent and under such conditions and limitations as may be provided in such regulations.

(2) *Application to liquidation extending over long period.*—The Commissioner is authorized to prescribe rules similar to those provided in this section with respect to the days within the period beginning with the date on which the first property is received in the intercorporate liquidation and ending with the day of its completion; and the extent to which, and the conditions and limitations under which, such rules are to be applicable.

(26 U. S. C. 1946 ed., Sec. 761.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 113 (b)–1. *Adjusted basis: General rule.*—The adjusted basis for determining

the gain or loss from the sale or other disposition of property, is the cost of such property or, in the case of such property as is described in paragraphs (1) to (16), inclusive, of section 113 (a), the basis therein provided, adjusted to the extent provided in section 113 (b).

The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, including the cost of improvements and betterments made to the property. * * *

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Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made.

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ART. 115–3. *Earnings or profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22 (a) of the Act or corresponding provisions of prior Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Acts are

brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. * * *

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ART. 115–11. *Effect on earnings or profits on certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning be-

fore January 1, 1936, or on or after such date) in exchange for its stock or securities, (see section 112 (b) (3)),

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraphs (1) and (2) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange.

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Treasury Regulations 101, promulgated under e Revenue Act of 1938:

ART. 115-11. *Effect on earnings or profits of certain tax-free exchanges and tax-free distributions.*—If, under the law applicable to the year in which any transfer or exchange of property after February 28, 1913, was made (including transfers in connection with a reorganization or a complete liquidation under section 112 (b) (6) and intercompany transfers of property during a period of affiliation), gain or loss was not recognized (or was recognized only to the extent of the property received

other than that permitted by such law to be received without the recognition of gain), then proper adjustment and allocation of the earnings or profits of the transferor shall be made as between the transferor and transferee corporations.

The general rule provided in section 115 (b) that every distribution is made out of earnings or profits to the extent thereof and from the most recently accumulated earnings or profits, does not apply to:

(1) The distribution, in pursuance of a plan of reorganization, by or on behalf of a corporation a party to the reorganization, to its shareholders of stock or securities in such corporation or in another corporation a party to the reorganization—

(A) in any taxable year beginning before January 1, 1934, without the surrender by the distributees of stock or securities in such corporation (see section 112 (g) of the Revenue Act of 1932); or

(B) in any taxable year (beginning before January 1, 1938, or on or after such date) in exchange for its stock or securities (see section 112 (b) (3))

if no gain to the distributees from the receipt of such stock or securities was recognized by law.

(2) The distribution in any taxable year (beginning before January 1, 1938, or on or after such date) of stock or securities, or other property or money, to a corporation in complete liquidation of another corporation, under circumstances described in section 112 (b) (6) of the Revenue Act of 1936 or section 112 (b) (6) of the Revenue Act of 1938.

(3) The distribution in any taxable year (beginning after December 31, 1937) of

stock or securities, or other property or money, in the case of an exchange or distribution described in section 371 (relating to exchanges and distributions in obedience to orders of the Securities and Exchange Commission), if no gain to the distributees from the receipt of such stock, securities, or other property or money was recognized by law.

(4) A stock dividend which was not subject to tax in the hands of the distributee because either it did not constitute income to him within the meaning of the sixteenth amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

A distribution described in paragraph (1), (2), (3), or (4) above does not diminish the earnings or profits of any corporation. In such cases, the earnings or profits remain intact and available for distribution as dividends by the corporation making such distribution, or by another corporation to which the earnings or profits are transferred upon such reorganization or other exchange. In the case, however, of amounts distributed in liquidation (other than a tax-free liquidation or reorganization described in paragraph (1), (2), or (3) above) the earnings or profits of the corporation making the distribution are diminished by the portion of such distribution properly chargeable to earnings or profits accumulated after February 28, 1913, after first deducting from the amount of such distribution the portion thereof allocable to capital account.

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